

Section 87 of the Indian Act: Recent Developments in the Taxation of Investment Income

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INTRODUCTION

This paper is an overview and update with respect to certain tax issues surrounding section 87 of the Indian Act (“the section 87 exemption”).¹ The paper focuses on the section 87 exemption and the taxation of investment income, in particular investment income earned by Indian individuals rather than Indian bands. The first part of the paper provides some background that is necessary to understanding the section 87 issues. Generally, the section 87 exemption is shrinking to such a point that for bands the more significant exemptions are those found in the Income Tax Act² (“the ITA”) under paragraphs 149(1)(c), (d), and (l) as opposed to section 87.³ As the availability of section 87 narrows to the point where it has essentially vanished, it will be important that practitioners bring creativity and standard planning practices to First Nations taxpayers. Tax exemption arguments based on treaty and aboriginal rights will also continue to grow in importance.

In this paper, in order to follow the definitions and wording in the Indian Act, I will generally refer to First Nations people and First Nations as Indians and bands respectively.

SECTION 87 OF THE INDIAN ACT

Unless a tax exemption based on a specific statutory, treaty, or aboriginal right is available, Indians and non-Indians alike are subject to the same taxation systems and rates. The main statutory exemption for Indians is found in section 87 of the Indian Act.

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1 Unless otherwise stated, all statutory references are to sections of the Indian Act, RSC 1985, c. I-5, as amended.

2 RSC 1985, c. 1 (5th Supp.), as amended.

3 For an excellent review of these issues, see J. Peter Ranson, “Doing Business with First Nations—Tax Issues Part II,” in *1998 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1998), tab 14.

Section 87 currently reads as follows:

87(1) Property exempt from taxation—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 a band situated on a reserve.

(2) Idem—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 (b) or is otherwise subject to taxation in respect of any such property.

Section 90 deems personal property provided to an Indian or a band pursuant to a treaty or an ancillary agreement with the federal government to always be situated on a reserve.⁴

Paragraph 81(1)(a) of the ITA explicitly recognizes the section 87 tax exemption as follows:

81(1)(a) There shall not be included in computing the income of a taxpayer from a taxation year,

(a) Statutory exemptions—an amount that is declared to be exempt from income tax by any other enactment of Parliament, other than an amount received or receivable by an individual that is exempt by virtue of a provision contained in a tax convention or agreement with another country that has the force of law in Canada.

Although paragraph 81(1)(a) of the ITA appears to be complementary to section 87, section 87 overrides any other federal or provincial taxing statute, including any provision of the ITA. A federal or provincial law that has the effect of taxing the personal property of an Indian or band situated on a reserve is invalid against that Indian and that property. The specific type of exemption referred to in ITA section 81 is not required.

In order for the section 87 exemption to apply, the following requirements must be met:

- 1) the government levy from which exemption is sought must be a tax;
- 2) the person claiming the exemption must be an Indian or a band; and
- 3) the tax must be levied in respect of an Indian's or a band's interest in either
 - a) reserve or surrendered land, or
 - b) personal property situated on a reserve.

Only an "Indian" or a "band" can claim the section 87 exemption. Under section 2(1) of the Indian Act, an "Indian" is defined as "a person who pursuant

⁴ *Mitchell v. Peguis Indian Band* (1990), 71 DLR (4th) 193 (SCC); and *The Queen v. Kakfwi*, 99 DTC 5639 (FCA).

to this Act is registered as an Indian or is entitled to be registered as an Indian.” Thus, under this definition, some aboriginal persons such as non-status Indians, Métis, and Inuit are not eligible for the section 87 exemption.

Under section 2(1), a “band” is defined as a “body of Indians for whose use and benefit in common, lands, the legal title to which is vested in Her Majesty the Queen, have been set apart before, on or after the 4th day of September 1951, or for whose use and benefit in common, moneys are held by Her Majesty, or who have been declared to be a band by the Governor in Council.” A corporation is not an Indian or a band and thus is not entitled to the section 87 exemption, even if all its shareholders are Indians or a band. The same restriction applies to a trust.⁵

Under section 87, both real and personal (tangible and intangible) property may be eligible for exemption from taxation.

Perhaps the most significant point in the area of personal property has to do with the classification of “income” and “taxable income” as personal property. In *Nowegijick v. The Queen*,⁶ the Supreme Court of Canada held that personal property includes income and taxable income and that such income of an Indian or a band will be exempt from the application of income taxation if it can be said to be situated on a reserve.

The requirement that the personal property of an Indian or a band be situated on a reserve is perhaps the most problematic issue with respect to the availability of the section 87 exemption. It is not generally difficult to determine where tangible personal property is situated. Intangible property is more problematic. For example, in the case of a contract debt, the situs of the income received could be the residence of the debtor or the recipient or perhaps the place where payment is made. The courts have had numerous opportunities to comment on the situs of income.

THE NOWEJIJICK PRINCIPLE

Until the decision in *Williams v. The Queen*⁷ (discussed below), the leading case in Canada dealing with the taxation of income (that is, debts, wages, and business income) payable to an Indian was *Nowegijick*.

In *Nowegijick*, the taxpayer was a status Indian living on a reserve. He performed work off the reserve as a logger for a corporation that had its head office on reserve and paid him by cheque from the head office. The Canada Customs and Revenue Agency (“the CCRA,” formerly Revenue Canada) considered that

5 A trust may be resident on a reserve if the trustees are resident on a reserve and income paid out of a trust to an Indian beneficiary may be exempt. Income left in the trust is taxable.

6 [1983] 1 SCR 29.

7 92 DTC 6320 (SCC).

the wages the taxpayer received were included in taxable income and proceeded to assess the taxpayer accordingly. The Supreme Court of Canada held that for the purposes of section 87, salary or wages are the personal property of an Indian. Furthermore, the court stated that the inclusion of this personal property in the calculation of an Indian's income would give rise to a tax in respect of the personal property of that Indian within the meaning of the Indian Act.

Nowegijick was also the leading decision with respect to the situs of income. In that case, the simple test taken from conflict of law principles was applied. The Supreme Court of Canada held that wages or salaries are normally situated for conflict of law purposes where the debtor (that is, the employer) is to be found, because that is the place where the debt can be enforced. Hence, if the payer (that is, the employer) was resident on a reserve, the debt was situated on the reserve and thus the income was not subject to tax. This test was generally applicable to all forms of income received by an Indian.

Until *Williams*, wages of an Indian were tax-exempt no matter where the work was carried out and no matter where the Indian resided, provided that the payer of the wages resided on the reserve. This test also applied to other forms of income such as dividends and interest. This test allowed most Indians to know, with some certainty, when they would be taxed in respect of any income they received. Furthermore, the test allowed Indians to establish a tax structure whereby they lived and worked off the reserve but earned income through a company or trust located on a reserve, and therefore avoided income taxation under section 87.

MITCHELL, WILLIAMS, AND THE ECONOMIC MAINSTREAM

The "connecting factors test," which will be reviewed below, and the decision in *Williams* arise out of the *Mitchell* case.

Mitchell

In *Mitchell*, a law firm acted for an Indian band to obtain recovery of sales taxes improperly paid to the Manitoba government. The firm was successful, but the band apparently did not pay its legal bill. The law firm sued the band and attempted to garnish the funds held by the Manitoba government. The band argued that the funds were deemed situated on a reserve by virtue of section 90 and therefore exempt from garnishment under section 89, even though they were actually situated off the reserve. The trial judge and the Manitoba Court of Appeal accepted this reasoning; however, the Supreme Court of Canada, in a split decision, did not.

The Supreme Court of Canada was concerned with giving section 90 a broad interpretation. La Forest J stated:

In summary, the historical record makes it clear that ss. 87 and 89 of the *Indian Act*, the sections to which the deeming provision of s. 90 applies, constitute part

of a legislative “package” which bears the impress of an obligation to native peoples which the Crown has recognized at least since the signing of the Royal Proclamation of 1763. From that time on, the Crown has always acknowledged that it is honour-bound to shield Indians from any *efforts by non-natives to dispossess Indians of the property which they hold qua Indians, i.e., their land base and the chattels on that land base.*

It is also important to underscore the corollary to the conclusion I have just drawn. The fact that the modern-day legislation, like its historical counterparts, is so careful to underline that exemptions from taxation and distraint apply only in respect of personal property situated on reserves demonstrates that *the purpose of the legislation is not to remedy the economically disadvantaged position of Indians by ensuring that Indians may acquire, hold, and deal with property in the commercial mainstream on different terms than their fellow citizens. An examination of the decisions bearing on these sections confirms that Indians who acquire and deal in property outside lands reserved for their use, deal with it on the same basis as all other Canadians.* [Emphasis added.]⁸

La Forest J further stated:

It would follow that if an Indian band concluded a purely commercial business agreement with a private concern, the protections of ss. 87 and 89 would have no application in respect of the assets acquired pursuant to that agreement, *except, of course, if the property was situated on a reserve. It must be remembered that the protections of ss. 87 and 89 will always apply to property situated on a reserve.* But the protections of ss. 87 and 89 would attach, regardless of *situs*, if the same band concluded a similar commercial agreement and acquired the same property for the same business ends, but happened to conclude the agreement with a provincial Crown acting in a purely commercial capacity. In other words, the statutory notional *situs* of s. 90(1)(b) would apply or not apply according as to whether an Indian band concluded a purely commercial agreement with one party as opposed to another. This result, in my respectful view, defies plausible explanation. [Emphasis added.]⁹

This language and the *Mitchell* decision have been used by many, including lower courts, to support the proposition that once an Indian or a band enters the “economic mainstream,” any income earned will be subject to tax. This is not what La Forest J stated. What La Forest J stated was that if a band entered into the economic mainstream and acquired property, it could not expect to avail

8 *Mitchell*, supra footnote 4, at 226-27. It is interesting to note that there was very little evidence before the Supreme Court as to the purpose of section 87. Rather than basing its decision on a purposive approach to statutory interpretation, the court could simply have protected the cash from garnishment because it was improperly taken off a reserve by the government.

La Forest J did not cite any cases for the proposition italicized in the quoted extract, but it is important that he spoke of Indians acquiring, holding, and dealing in property outside a reserve on the same basis as other Canadians. He did not speak of only “acquiring” property outside a reserve.

9 *Ibid.*, at 233.

itself of the deemed situs rules in section 90. If, however, the assets were in fact and in law situated on the reserve, the protection of sections 87 and 89 would apply whether or not the band or Indian had entered the economic mainstream. Section 87 always applies to personal property situated on a reserve no matter where such property is acquired. In my view, to say that intangible or tangible personal property that is acquired in the economic mainstream is never situated on a reserve is to add words to section 87 that are not found in the provision. It is, I suggest, important that La Forest J spoke of Indians acquiring *and* dealing with property outside reserves on the same basis as other Canadians. He did not say the same thing about property that was acquired off reserve and then situated on reserve, yet later cases appear to suggest this by holding that income from off-reserve activities cannot be situated on a reserve.¹⁰

In *Recalma et al. v. The Queen*,¹¹ the issue of a separate economic or commercial mainstream test was placed squarely before the court. The taxpayer was unsuccessful in *Recalma*; however, the court stated that there was no separate “commercial mainstream” test to determine the application of section 87. However, entering the commercial mainstream was stated to be an aid to be taken into account in determining situs and weighing the relevant connecting factors. Practically speaking, the “aid” amounts to a test.

Williams and the “Connecting Factors” Test

In *Williams*, a status Indian had been employed by an Indian band on a reserve. He had lived on the reserve during his employment, and all of his duties of employment were carried out on the reserve. Furthermore, Mr. Williams was paid on the reserve. Thus, on the basis of the decision in *Nowegijick*, Mr. Williams’s income from employment was not subject to income taxation owing to section 87. The issue was whether unemployment insurance benefits received by Mr. Williams after termination of employment were taxable. Pursuant to *Nowegijick*, the benefits would arguably be taxable because the payer, the Crown, is not situated on a reserve.

The Supreme Court of Canada allowed the taxpayer’s appeal and adopted a “connecting factors” test to determine the situs of income. The court held that in order to decide whether or not the income of an Indian was subject to tax, it was necessary to first determine the purpose of the exemption from taxation in section 87. Furthermore, the court held that it was always necessary to keep in mind the nature of the benefits in question, and the manner in which the taxation fell upon such benefits.

10 *Southwind v. The Queen*, 98 DTC 6084 (FCA); and *Bell et al. v. The Queen*, 98 DTC 1857 (TCC), aff’d. 2000 DTC 6365 (FCA).

11 98 DTC 6238 (FCA).

The court cited with approval the reasons of La Forest J in *Mitchell*, in which he expressed the view that the purpose of the section 87 exemption was to preserve the entitlement of Indians to reserve lands and to ensure that the use of their property on reserve lands was not eroded by the ability of the government to tax or of creditors to seize. The purpose of the exemption was not to confer a general economic benefit upon Indians.¹²

Gonthier J, speaking for a unanimous court, stated the following in *Williams*:

Therefore, under the *Indian Act*, an Indian has a choice with regard to his personal property. The Indian may situate this property on the reserve, in which case it is within the protected area and free from seizure and taxation, or the Indian may situate this 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.*

The purpose of the *situs* test in s. 87 is to determine whether the Indian holds the property in question as part of the entitlement of an Indian *qua* Indian on the reserve. *Where it is necessary to decide amongst various methods of fixing the location of the relevant property, such a method must be selected having regard to this purpose.* [Emphasis added.]¹³

The crux of the *Williams* decision appears to be that an Indian has a choice: the Indian may remain segregated from society on the reserve and be exempted from tax, or the Indian may join mainstream society and pay tax like all other citizens of Canada.

After resolving this issue, the court examined the nature of unemployment insurance benefits and concurred with the decision of *Nowegijick* that income was personal property of an Indian that could be situated on a reserve. Using this reasoning, Gonthier J concluded that unemployment insurance benefits were personal property of an Indian, which, in a given situation, might or might not be situated on a reserve.

The issue therefore became what is the test for determining the *situs* of intangible personal property of an Indian such as unemployment insurance benefits. The court reviewed the decision in *Nowegijick*, and an earlier decision of the Federal Court—Trial Division in *The Queen v. The National Indian Brotherhood*,¹⁴ and expressly declined to follow the simple test set out in these decisions, which was that the *situs* of intangible personal property of an Indian was the *situs* of the payer of the debt.

12 See the quotation from *Mitchell*, *supra*, at footnote 8.

13 *Supra* footnote 7, at 6324.

14 78 DTC 6488 (FCTD).

The court took the view that this “simple test” was applicable only for conflict of law purposes and its use was entirely out of keeping with the scheme and purpose of the Indian Act. Gonthier J stated:

In resolving this question, it is readily apparent that to simply adopt general conflicts principles in the present context would be entirely out of keeping with the scheme and purposes of the *Indian Act* and the *Income Tax Act*. The purposes of the conflict of laws have little or nothing in common with the purposes underlying the *Indian Act*. It is simply not apparent how the place where a debt may normally be enforced has any relevance to the question of whether to tax the receipt of the payment of that debt would amount to the erosion of the entitlements of an Indian *qua* Indian on a reserve. The test for *situs* under the *Indian Act* must be constructed according to its purposes, not the purposes of the conflict of laws. *Therefore, the position that the residence of the debtor exclusively determines the situs of the benefits such as those paid in this case must be closely reexamined in light of the purposes of the Indian Act.* It may be that the residence of the debtor remains an important factor, or even the exclusive one. However, this conclusion cannot be directly drawn from an analysis of how the conflict of laws deals with such an issue. [Emphasis added.]¹⁵

Gonthier J went on to develop a new test for determining the situs of intangible personal property of an Indian. The court was mindful of the fact that a test that was overly rigid would have the same problem as the test in *Nowegijick* in that it would probably not take into account the purpose for which the section 87 exemption arose in the first place. Specifically, it would be open to potential manipulation and abuse in focusing on factors that would miss the entire purpose for which the exemption was given. On the other hand, the court recognized that a loosely structured test that required a court to balance all of the relevant connecting factors in a given case had the advantage of flexibility but might not provide the predictability that taxpayers need in planning their taxation affairs. The court chose flexibility. Gonthier J then went on to lay out a conceptual framework as follows:

The first step is to identify the various connecting factors which are potentially relevant. These factors should then be analyzed to determine what weight they should be given in identifying the location of the property, in light of three considerations: (1) the purpose of the exemption under the *Indian Act*; (2) the type of property in question; and (3) the nature of the taxation of that property. The question with regard to each connecting factor is therefore what weight should be given that factor in answering the question whether to tax that form of property in that manner would amount to the erosion of the entitlement of the Indian *qua* Indian on a reserve.¹⁶

15 *Supra* footnote 7, at 6325. I am still not certain what the term “entitlements of an Indian *qua* Indian” means except that it is simply the Indian’s interest in reserve lands and the chattels on those lands (that is, it is irrelevant where the chattels are acquired or generated or what the chattels are: *Mitchell*, *supra* footnote 4, at 226).

16 *Supra* footnote 7, at 6326.

The problem with the connecting factors test, as indicated above, is that it provides no certainty to the taxpayer and the taxpayer's advisers.¹⁷ The *Williams* decision simply ensured that numerous section 87 cases would have to come before the courts and indeed would have to proceed to the Supreme Court of Canada. Unless two cases have exactly the same fact pattern, certainty and guidance are impossible to attain. Interestingly, *Williams* actually appeared to show a broadening of the section 87 exemption by ensuring that it applied whenever its application was consistent with the purpose of the section. It has not worked out that way.

INVESTMENT INCOME

*Recalma et al. v. The Queen*¹⁸ was the first case after *Williams* to deal with investment income.

Until *Recalma*, the CCRA had generally applied the situs of the debtor test to investment income.¹⁹ No tax was applied to deposit accounts situated at reserve branches of banks. Tax was applied to term deposits, guaranteed investment certificates, and other securities, which were said to be situated at the head office of the bank. Dividends were exempt if the payer was resident on a reserve. The taxation of trust income generally also depended on the residence of the trust. Planning was based on ensuring that the payer was situated on a reserve.

In *Recalma*, the appellants were all status Indians living in Qualicum Beach, British Columbia, on a designated Indian reserve. The appellants each invested some of their money in banker's acceptances and investment trusts purchased at the Park Royal South branch of the Bank of Montreal located on reserve lands (Squamish). The appellants claimed that the income earned from the investments was situated on a reserve and was exempt from taxation under section 87. The minister of national revenue ("the minister") argued that the investment income was earned off the reserve in the economic mainstream and thus was liable to taxation.

In the Tax Court of Canada, the following was found to be significant evidence:

- The appellants were status Indians who were fisherman or employed in the fishing industry, and their respective businesses were operated from their reserve-based homes.
- The appellants had all held either elected or employment offices with their bands, and Mr. Recalma Sr. was a hereditary chief of the Qualicum band.

17 The analysis in *Williams* is in sharp contrast to the decision in *65302 British Columbia Ltd. v. The Queen*, 99 DTC 5799 (SCC), where the court placed great weight on certainty in tax matters and refused to read language into the ITA to prohibit the deduction of fines and penalties.

18 96 DTC 1520 (TCC), appeal denied 98 DTC 6238 (FCA).

19 The CCRA's position was set out in former *Interpretation Bulletin* IT-62, August 18, 1972, cancelled by IT-397RSR on July 15, 1995.

- The appellants were supportive of band life and sought to financially support native business or enterprises.
- The whole economic, social, and cultural life of the appellants revolved around the reserve and the Indian people.
- The funds used to purchase the investment instruments came from money the appellants had derived from employment income or the sale of assets, none of which was subject to taxation owing to section 87.²⁰
- The money earned by the appellants from investments was, in large measure, spent on the reserve for personal matters, to maintain traditional ways of living, and to preserve Indian artifacts and values.
- The appellants also engaged in traditional ways of helping their people through food distribution (fish) and wealth distribution through the potlatch system.
- All purchases by the appellants, if possible, were made on the reserve; however, the appellants did state that some purchases made on the reserve from commercial entities off reserve were made in such a manner as to obtain exemptions from sales taxes.
- The appellants were attracted to the Bank of Montreal and, in particular, to the Park Royal South branch as being a branch located on a reserve that could give them banking service and allow them tax-exempt status in respect of interest earned on deposits. The appellants had been customers of this bank for many years.
- The appellants purchased banker's acceptances through the bank branch. Banker's acceptances are short-term notes issued by a third party whose principal and interest are guaranteed by a bank. Such banker's acceptances are sold at a discount and are generally redeemed at face value. When a customer approached a branch of the Bank of Montreal to purchase banker's acceptances, an employee of the branch contacted the bank's treasury department in Toronto or possibly Vancouver to find out what the bank had available. Once the sale of acceptances was made to the customer of the branch, the treasury department debited the customer's bank account for the amount of the sale. Normally the acceptances were kept by the bank in Toronto because acceptances are in bearer form; however, the acceptances could have been held by the appellants directly on the reserve. Upon the maturity date of an acceptance, the customer's bank account was credited directly with the proceeds of the instrument. The income realized from the banker's acceptances was taxed as interest income under subsection 9(1) of the ITA.
- The appellants purchased certain mutual funds through the same branch. The funds purchased were units in the First Canadian Money Market Fund, which

20 It is to be noted that after the *Southwind* and *Bell et al.* cases, *supra* footnote 10, the CCRA may have sought to tax this income.

invested in short-term debt issued by Canadian governments and corporations, and units in the First Canadian Mortgage Fund, which invested in mortgages. Both funds were managed by the Bank of Montreal Investment Management Limited, a wholly owned subsidiary of the Bank of Montreal having its head office in Toronto. Each fund was an unincorporated trust created by declaration of trust. When a customer approached a branch of the Bank of Montreal to purchase units in the mutual funds, a sales representative for the funds at the branch forwarded a subscription request to the fund's head office for approval. Once the application was accepted, the money used to buy the units in the mutual fund was transferred either by the branch or by the customer to the bank's head office. When the customer wanted to redeem the units, the sales representative at the branch forwarded a redemption request to the head office. Upon redemption, proceeds could be deposited directly into the customer's bank account at the branch or at any other financial institution, or could be issued to the customer in the form of a cheque. The income realized from the investment in mutual funds was included in income and taxed pursuant to subsection 104(13) of the ITA as a distribution from the trust.

At the Tax Court, His Honour Judge Hamlyn had no difficulty in determining that the *Williams* connecting factors test applied not just to unemployment insurance benefits and employment income, but also to investment income. The judge stated that the following connecting factors were to be considered to determine the situs of the investment income:

- 1) the residence of the appellant;
- 2) the origin or location of the capital used to acquire the securities;
- 3) the location of the bank branch where the securities were acquired;
- 4) the location where the investment income was to be used;
- 5) the location of the investment instruments themselves;
- 6) the location where the investment income payment is made; and
- 7) the nature of securities—in particular,
 - a) the residence of the issuer;
 - b) the location of the issuer's income-generating activity from which the investment was made; and
 - c) the location of the issuer's property in the event of a default that could be subject to potential seizure.

The court went on to state that it was important to consider the nature of the property in question. The property in question was an "income stream" from the securities owned by the appellants in the form of interest, not the securities themselves. The court thus turned its focus away from the location of capital and the securities to the location of the income stream.

The court held that the factors listed that pointed solely to the location or source of the securities themselves were to be given less weight than other

factors. Those former factors included the origin of the capital that was used to buy the securities, the location of the bank branch where the securities were bought, and the location of the securities themselves. The court also held that the location where the investment income was to be used when received was a factor of lesser importance, but nonetheless one to be considered. Finally, the court held that the residence of the appellants on the reserve was of great significance. The above factors all pointed to the income being situated on a reserve. The personal factors showed a strong connection to the reserve.

The court held that the factors that were to be given the most weight were those factors going to the “nature of the securities,” being (1) the residence of the issuer; (2) the location of the issuer’s income-generating activity from which the investment is made; and (3) the location of the issuer’s property in the event of a default that could be subject to potential seizure. The focus of the court’s analysis was on the issuer and the issuer’s income-generating activity, not on the Indian investor or the capital.

His Honour Judge Hamlyn stated:

All the transactions involved with the investment instruments including location of the instruments, the residence of the issuers, the acceptance of the orders and the interest generating activity of the investment instruments were all located or conducted off the reserve.

The income realized from a banker’s acceptance is taxed as interest income. The income from the managed funds is also taxed as interest income. The income stream for these financial instruments starts with the companies who originally issued the banker’s acceptances or the managed funds then passes through the Bank of Montreal before being paid to the Appellants. The act of buying the investment instruments in question is the act of making a choice to enter into an investment transaction with all its parameters. Thus, to earn an income stream from the economic mainstream from economic activities located, generated and structured off the reserve is the choice the Appellants made. The Appellants, by making the choice, chose to enter the main economic stream of normal business conducted off the reserve.

As a result, the personal property of the Appellants (the investment income) is not situated on a reserve.²¹

In effect, the court held that while the appellants acquired the investments at an on-reserve branch, the branch acted only as a conduit or an agent for off-reserve issuers and off-reserve transactions. The court appeared to place greatest weight on the location of the issuer’s income-earning activities.

The Federal Court of Appeal in *Recalma*, in a short oral decision, upheld the decision of the trial judge. Linden J wrote the decision for a unanimous court. The language of the court and its decision are important in many respects. The court quite appropriately stated that there was nothing wrong with Indians

21 *Recalma* (TCC), supra footnote 18, at 1524.

arranging their tax affairs in order to minimize their tax burden by planning to make use of the section 87 exemption.²² The only issue in the case was to determine whether or not the taxpayers had chosen a structure that entitled them to the section 87 exemption. This ability to plan one's affairs to take advantage of the section 87 exemption is an important principle.

There is, however, some disturbing language in the Federal Court's decision. Specifically, Linden J stated:

In evaluating the various factors the Court must decide where it "makes the most sense" to locate the personal property in issue in order to avoid the "erosion of property held by Indians *qua* Indians" so as to protect the traditional Native way of life. It is also important in assessing the different factors to consider whether the activity generating the income was "intimately connected to" the Reserve, that is, an "integral part" of Reserve life, or whether it was more appropriate to consider it a part of "commercial mainstream" activity. (See *Folster v. The Queen* (1997), 97 DTC 5315 (F.C.A.)) We should indicate that the concept of "commercial mainstream" is not a test for determining whether property is situated on a reserve; it is merely an aid to be used in evaluating the various factors being considered. It is by no means determinative. The primary reasoning exercise is to decide, looking at all the connecting factors and keeping in mind the purpose of the section, where the property is situated, that is, whether the income earned was "integral to the life of the Reserve," whether it was "intimately connected" to that life, and whether it should be protected to prevent the erosion of the property held by Natives *qua* Natives.²³

I have difficulties with language that suggests that the connecting factors test is used to determine where it "makes the most sense," or where it is "most appropriate," to locate property, and whether or not the purpose of section 87 is to protect a traditional native way of life. To ask where it "makes the most sense" to situate the property is to create a test that is impossible to apply. The Supreme Court of Canada has stated that the purpose of the exemption is to protect property held by natives on reserve.²⁴ The Supreme Court of Canada has never referred to section 87 as protecting a traditional way of life. Nor did the *Williams* case state that one must look to all the factors to determine where it "makes the most sense" to locate property. The issue is simply where, at law, the income is situated, taking into account the purpose of the section 87 exemption.

Linden J held that where investment income is at issue, it must be viewed in relation to its connection to the reserve, its benefit to the traditional native way of life, the potential danger to the erosion of native property, and the extent to

22 *Recalma* (FCA), *supra* footnote 18, at 6239. Also see *Shilling v. MNR*, 2000 DTC 5441 (FCTD). This case is under appeal, but it is important because it placed great weight on the planning completed by the Indian and the true legal relationships created.

23 *Recalma* (FCA), *supra* footnote 18, at 6239-40.

24 *Mitchell*, *supra* footnote 4.

which it may be considered to be derived from economic mainstream activity. The court stated that the Tax Court judge was correct in placing considerable weight on the way in which the investment income was generated and where it was generated. The court held that investment income, being passive income, is not generated by the individual work of the taxpayer, but that arguably the work is done by the money that is invested across the land.²⁵ Thus, the court held that the focus of the analysis had to be on the issuers of the securities—that is, the corporations that offered the banker’s acceptances and the managers of the mutual funds, which were not located on reserves. The court also placed great weight on where the assets of the issuers of the securities in question were located, which would be important in the case of default. Linden J stated:

Thus, in our view, taking a purposive approach, the investment income earned by these taxpayers cannot be said to be personal property “situated on a reserve” and, hence, is not exempt from income taxation.

To hold otherwise would open the door to wealthy Natives living on reserves across Canada to place their holdings into banks or other financial institutions situated on reserves and through these agencies invest in stocks, bonds and mortgages across Canada and the world without attracting any income tax on their profits. We cannot imagine that such a result was meant to be achieved by the drafters of section 87. The result may, of course, be otherwise in factual circumstances where funds invested directly or through banks on reserves are used exclusively or mainly for loans to Natives on reserves. When Natives, however worthy and committed to their traditions, choose to invest their funds in the general mainstream of the economy, they cannot shield themselves from tax merely by using a financial institution situated on a reserve to do so.²⁶

Linden J appeared to regard the bank as simply an agent used to connect the otherwise off-reserve transactions to the reserve. In that regard, the case may be somewhat narrow.

It is important to note that, in the judgment, Linden J expressly stated that the investments he was dealing with were very different from ordinary bank deposits in a reserve bank and branch.

With respect to banker’s acceptances and other fixed-income instruments, the emphasis placed on the income-earning activity of the issuer seems misplaced. In the case of a fixed-income security, there is legally no further income-generating activity of anyone that needs to take place beyond that which takes place when a taxpayer purchases the securities. It is of no legal concern to the taxpayer whether the issuer of the banker’s acceptances or the Bank of Montreal generates any income during the period of time in which the banker’s acceptances are outstanding. There may, in fact, be none. The mere step of acquiring a fixed-income investment generates the right to receive a certain fixed amount of income. The

25 This argument completely ignores the work done to generate the capital.

26 *Recalma* (FCA), supra footnote 18, at 6240.

income-generating activity that matters is the generation of the original capital and the acquisition of the securities. Of course, the issuer has to pay the income to the investor, but this might be paid out of capital, other borrowings, or unrelated earnings (perhaps employment income).

Post-*Recalma*, the key factors in analyzing the situs of investment income appear to be the residence of the debtor or issuer, the location of the income-generating activity of the issuer, and the location of the issuer's assets in the case of default. The location of the income-generating activity is the most important factor. On the basis of the language used in *Recalma*, the residence of the issuer will, I believe, be of limited importance where the issuer is simply arranged as a conduit so as to create a connection to the reserve, or is an entity that is controlled by the investor. For example, I am of the view that generally interposing corporations, partnerships, or trusts resident on a reserve and controlled by Indians between the Indians and the ultimate issuer will be of limited use given the attitude of the CCRA and the courts to this exemption. In order to have any effect, the intermediary certainly must hold the securities on its own account and not on behalf of the Indian person. Where the issuer is not connected to the Indian, is a resident on a reserve, and keeps its assets on a reserve, the residence may be given greater weight than the location of the income-generating activity.

It is simply not clear how to apply this analysis. For example, one Indian living on reserve lends money at a fixed or floating interest rate to another Indian on reserve. The borrower uses the funds to invest in rental property off reserve and uses the income to pay interest on the debt. Is the interest taxable? The issuer is resident on reserve, but has assets off reserve and earns income off reserve to pay the interest. If the location of the income-generating activity governs, the interest is taxable. What if the borrower earns rental income but uses section 87 exempt employment income to pay the interest? The income-generating activity used to pay the interest is on reserve. The interest should thus be exempt. I suggest that the focus is simply on the wrong person and the wrong income stream. In the example, the lender has chosen to accept a fixed rate of return and all of the investment activity takes place on reserve. Taking into account the purpose of the exemption and the nature of the securities, the income should be exempt. To hold otherwise clearly erodes the lender's personal property on the reserve. With respect to the "economic mainstream," the lender has chosen to avoid it by lending at a fixed rate on a reserve. The same analysis would apply to fixed dividends on preferred shares issued by a company resident on reserve. What if an Indian invests in a corporation resident on reserve that conducts a financing business on reserve? All investment decisions and contracts are made on reserve, but borrowers take the money off reserve. Whose income-generating activities count—those of the corporations or those of the ultimate borrower? There is simply no guidance.

If one is taking a "purposive" approach to section 87, I also suggest that even in the case of mutual funds, stocks, and other "participating" investments, where

off-reserve income-generating activity is important, more weight should be placed on the overall connection of the capital and the investor to a reserve. The purpose of section 87 is to protect an Indian's personal property situated on a reserve. The purpose is not only to protect property situated and generated on a reserve. It should not matter how income gets on a reserve, but only that it is situated on a reserve at the time of the incidence of taxation (or, with respect to section 89, at the time of seizure). This is the analysis applied to sales tax and tangible personal property.²⁷ The problem with the connecting factors test and the purposive approach is that it has led to courts making moral judgments, such as that wealthy natives who are otherwise strongly connected to their reserve should not be able to invest in the economic mainstream along with ordinary Canadians and claim the section 87 exemption. With all due respect, neither *Mitchell* nor section 87 states this proposition. The former test, which relied on pure legal principles, was focused on the transaction that ordinarily gives rise to the income and the taxation—that is, the payment. If the payer and the payment were on reserve, no tax applied. I suggest that the test was simple, fair, and provided certainty. Taxpayers were able to plan their affairs.

Placing great weight on the income-generating activity of the issuer is in keeping with most of the employment income and business income cases, which have attached great importance to the location of the employment itself and the business activities that generate the income.²⁸ Certainly this is the position that the CCRA appears to be taking. For example, even if a financial institution has its head office on reserve, if its income cannot be shown to be exclusively or mainly generated on a reserve, the CCRA can be expected to deny the section 87 exemption in respect of income earned from securities or bank accounts issued by that institution.

The only conclusion that can be drawn from the decision in *Recalma* is that if the funds used to pay the investment income are generated off reserve, probably the investment income will be taxable. The decision, in effect, erodes the section 87 exemption. It is difficult to see how this is in keeping with the purpose of the exemption. Leave to appeal to the Supreme Court of Canada in *Recalma* was denied.

POSITION OF THE CANADA CUSTOMS AND REVENUE AGENCY

The complete uncertainty generated by the connecting factors test can be seen from the volume of published responses by the CCRA to questions from taxpayers and their advisers. The volume is enormous.

27 *Union of NB Indians v. NB (Minister of Finance)* (1998), 161 DLR 4th 193 (SCC).

28 See *supra* footnote 10.

The CCRA's position on the section 87 exemption and investment income can be seen in these published letters and in the CCRA's assessing practice. After *Williams* and before *Recalma*, the CCRA took the position that all potential connecting factors needed to be examined to determine the situs of investment income or any income.²⁹ These factors would include the source of the funds to generate the capital, the residence of the individual investors, and the nature, type, and location of the securities in question. These are all factors analyzed in the *Recalma* case.

Since *Recalma*, however, the CCRA has changed this view. Now the dominant factor is stated to be the location of the income-generating activities of the issuer; however, the Indian must also live and work on reserve and the capital must be from exempt sources for the investment income to be exempt.³⁰ Unless it can be shown that all or substantially all of the issuer's income-generating activity is on a reserve, the CCRA can be expected to assess, and this is what Indians are experiencing today. The CCRA, in my experience, assesses tax on all investment income earned by Indian people. There are a number of cases pending that will deal with bank accounts, guaranteed investment certificates, and term deposits. The difficulty for taxpayers is that it is almost impossible in the case of bank accounts or any more sophisticated instruments to prove where the income was generated to pay the interest. Effectively, the position means that the section 87 exemption is not available for almost all investment income.

The position of the CCRA can be summed up in this comment from an internal paper prepared by Roberta Albert:

While the court considered all of these factors it placed considerable weight on (g)(II)—the location of the income generating activity of the issuer of the securities. In *Recalma*, the income in question was interest from banker's acceptances and income from mutual funds. Basically the Court concluded that income from these investments started with companies off reserve and was passed through the bank on reserve to the taxpayers. It was held that the investment income was not personal property situated on a reserve. The Court concluded that in making these investments the taxpayers chose to invest in the economic mainstream of normal business conducted off reserve.

In our view, the decision supports the position that income earned in the economic mainstream is so strongly connected to a location off reserve that it will generally outweigh other factors that may indicate the income is connected to a location on reserve.

This decision was appealed and the decision, which confirmed the original decision, was rendered on March 27, 1998.

As a result, while the determination in any situation would involve a review of all relevant connecting factors and consideration as to how much weight should

29 CCRA document no. 9627905, November 6, 1996.

30 CCRA document nos. 9911647, July 16, 1999, and 2000-0029195, June 16, 2000.

be given to each factor, the major determining factor is the source of the income. Based on the *Recalma* decision, unless the income can be identified as exclusively generated on the reserve, in our view, the income is not exempt.³¹

The CCRA has also stated:

In a situation where an on-reserve financial institution has less than 90% 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.³²

Essentially, the CCRA requires the taxpayer to trace the investment income to reserve-based generation. Further, the Indian must live and work on reserve. If this is not possible, the income is assessed as taxable. The CCRA will also assess even in cases where an agreement is reached between a customer and a financial institution that the capital in a bank account must be kept on a reserve. The CCRA is simply applying an "economic mainstream" test, not a connecting factors test.

The CCRA applies the same principle to dividend income and distributions from a trust. The income distributed must generally be shown to be generated from on-reserve income-generating activities; otherwise, it is subject to tax.

31 CCRA document no. 9812220, May 5, 1998.

32 CCRA document no. 9911647, July 16, 1999.

DEPOSIT ACCOUNTS

Before *Williams*, the CCRA assessed tax on interest from guaranteed investment certificates and term deposits but not on interest from bank accounts. The reason for the distinction was not clear but may have had to do with the statutory deemed situs for deposit accounts in section 461(4) of the Bank Act.³³ In an informal decision of the Tax Court of Canada in *Hill v. The Queen*,³⁴ the Tax Court held that interest earned from a bank account issued by an on-reserve branch of a bank was taxable. The facts in *Hill* were actually very good for the taxpayer. Mr. Hill lived on a reserve, taught school on a reserve, and farmed on a reserve. Mr. Hill placed a portion of his earnings in a one-year term deposit with the Royal Bank of Canada on a reserve. The court considered the income taxable because it was similar to the income earned by the appellants in *Recalma*, and because there was no evidence that the capital was used by the bank on reserve; rather, the funds were intermingled with all of the Royal Bank's funds used in the commercial mainstream.

The *Hill* case is, of course, of no precedential value because it is an informal decision. In my view, the case is simply incorrect. It is important to remember that in *Recalma*, Linden J drew a clear distinction between the sophisticated debt instruments the appellants in that case had invested in and a simple deposit account in an on-reserve branch.

Further, and this does not appear to have been argued in *Hill*,³⁵ section 461(4) of the Bank Act provides a statutory situs to a deposit account for all purposes. It deems the deposit account to be situated at the branch where it is issued and where the signature card is maintained. Further, the Bank Act states that all payments and all activity related to a deposit account must be at the branch where the deposit account is issued. Pursuant to section 461, if the branch of the bank where the deposit account is issued is on a reserve, the account is deemed to be situated on the reserve for all purposes. It would be surprising if the connecting factors test could override a statutory deemed situs provision. It is important, however, to note that the courts may draw a distinction between the location of the bank account itself and the location of the income stream that is generated by the bank account. Remember that in *Recalma* the court drew a

33 SC 1991, c. 46, as amended.

34 99 DTC 3504 (TCC).

35 The argument with respect to section 461 of the Bank Act was made in *Bennett v. The Queen*, 99 DTC 938 (TCC). The investment in question was an RRSP (and ultimately a RRIF). The court held that the RRSP was not a deposit account as defined in section 461 of the Bank Act and therefore did not decide the issue of situs of a deposit account. The RRSP withdrawals were held to be taxable since in the court's view the only connection to a reserve was that the RRSP had been acquired at an on-reserve branch. The court held that the taxpayer lived and worked off reserve and that the capital came from an off-reserve loan.

distinction between the capital itself and the income earned on that capital. It seems odd, however, that the capital could be deemed to be situated on a reserve by virtue of the statutory exemption in the Bank Act, and yet the income earned by that capital would be off reserve. This is especially the case where the interest income is paid into a bank account that is deemed situated on a reserve.

Finally, given that deposit accounts are interest-bearing instruments that are non-negotiable, it is surprising that the most significant connecting factor is one that is legally irrelevant to the income-earning process. The investment-earning activity of the bank issuing the bank account is not relevant to the rate of return earned by the Indian investor. The rate of return is determined independently of the use of the money by the bank. It could be argued that in choosing a simple deposit account at an on-reserve branch, an Indian person expressly chooses to avoid the other investments and activities that are available in the economic mainstream, and therefore limits his or her return accordingly. This choice to stay outside the economic mainstream should be respected, and the Indian should be treated as having earned exempt income under section 87. Further, great weight should be placed on the legal relationship as governed by section 461 of the Bank Act.

There are a number of test cases that should shortly clarify the position with respect to deposit accounts.

CAPITAL GAINS

Capital gains do not technically give rise to what would be called investment income; however, they are clearly related to investment activities. One can generally realize on an investment in a security by receipt of dividends or interest income, or by selling the instrument and realizing a capital gain.

It is not clear how—or even if—the connecting factors test will be applied to the taxation of capital gains. I suggest that the focus of the inquiry and the application of the connecting factors test should be on the location of the property at the time of the disposition, the location of the actual transfer in legal terms, and the place where payment is legally required to be made. This analysis would place the focus where it clearly should be, on the location of the asset being sold at the time it is being sold and at the time the gain is triggered. This analysis would be consistent with the principles that the Supreme Court of Canada has enumerated in relation to the sale of tangible personal property on reserve and the application of provincial sales tax. The Supreme Court has held that if the sale of the tangible personal property takes place on a reserve, no sales tax is applicable.³⁶ This is the case even if there is no other connection to the reserve and even if the assets in question will never again be used on a reserve,

36 *Supra* footnote 27.

but were simply brought onto the reserve to take advantage of the section 87 exemption. It is also to be noted that the Supreme Court stated that to the extent that the transaction took place off reserve, it would be taxable, even if all other connecting factors pointed to the reserve. I suggest that the same analysis should apply to any capital gain realized on the sale of property, whether it be tangible or intangible property.

Focus on the location of the transaction would lead to a situation whereby investment income earned on a security might be taxable, yet the capital gain earned on the sale of a security would not be taxable. While this may seem unusual, it is not. Before 1972, dividends realized on shares were taxable but capital gains were not. Even today, different tax rates apply to capital gains as opposed to investment income. Also, in certain situations, capital gains on shares are exempt from taxation through access to the lifetime capital gains exemption, and yet dividends received on those shares are taxable.

The only alternative application of the connecting factors test would be to look to the underlying activities of the issuer of the security and attempt to determine the location in which the inherent value in the security was created. This appears to be the view of the CCRA.³⁷

In dealing with the capital gains issue and the sale of a security, of course one would want to ensure that the parties to the transaction were on a reserve at the time of the transaction, that the securities were on the reserve at the time of the transaction, and that legally, in accordance with commercial law and the terms of the security instrument, the security instrument itself could be transferred on the reserve.

CONCLUSION

At this time, the overriding “connecting factor” in determining the situs of investment income appears to be the location of the income-generating activity of the payer. This is certainly the assessing position of the CCRA. To the extent that this activity is off reserve and in the “economic mainstream,” the investment income will be taxable. This test arguably makes no sense with respect to investment instruments whose return does not legally depend on activities in the economic mainstream. This test should not be applied to deposit accounts that have a statutory deemed situs. In any event, it is not consistent with the analysis in *Mitchell* or *Williams*.

The connecting factors test is frankly unworkable and unfair. It provides no certainty for taxpayers. Although *Williams* was decided nearly 10 years ago, it is still not clear whether interest on a bank account is subject to the exemption; nor

37 CCRA document no. 9421307, March 29, 1996. In this document, the CCRA stated that the capital gain had to be prorated on the basis of where the asset was used.

is it clear whether a capital gain arising on assets transferred on a reserve is exempt; nor is it clear whether interest paid on a fixed promissory note is taxable. The connecting factors test has led to an unreasonable fixation on the “economic mainstream” and to the determination of cases on the basis of a court’s view of where it “makes the most sense” to situate property. On this basis, how is any Indian person supposed to plan his or her affairs?

The Supreme Court of Canada, in devising the connecting factors test, aimed to preserve flexibility in determining the application of the section 87 exemption. Theoretically, the test should have also preserved fairness in linking availability of the exemption to its statutory purpose. However, the use of the test has drastically narrowed access to the exemption in respect of investment income. In the interests of equity and certainty for Indian taxpayers, it is clearly time to find a better way of administering section 87 in accordance with Parliament’s intent.