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DOCNUM 2009-0311861I7
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DESCKEY 26
RATEKEY 2
REFDATE 100721
SUBJECT Issues par. 149(1)(c) and proposed par.149(1)(d.5)
SECTION 149(1)(c); 149(1)(d.5); 149(1.2)
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Please note that the following document, although believed to be correct at the time of issue, may not represent the current position of the CRA. Prenez note que ce document, bien qu'exact au moment émis, peut ne pas représenter la position actuelle de l'ARC.

PRINCIPAL ISSUES:1. Is the Indian band a public body performing a function of government as that term is used in paragraph 149(1)(c)? 2. What are our views on the payment of management fees by a corporation owned by the band to the band such that the corporations income is reduced to nil. 3. Does the corporation qualify for the tax exemption provided by proposed paragraph 149(1)(d.5)?

POSITION: 1. Yes for years after XXXXXXXXXXXX ; likely yes for years before this time. 2. The payment of fees should be reviewed to determine if the amounts paid were reasonable. 3. Likely not, but should consider application of proposed subsection 149(1.2)

REASONS: 1. Passed section 81 and 83 by-laws (83 by-law accepted by INAC in XXXXXXXXXXXX). Before this time offered many municipal and provincial type services to members. 2. Management fees do not qualify under the policy for owner/shareholders of CCPC's'; section 67 would apply. 3. Corporation earns over 95% of income from activities carried on off the reserve. Consider whether proposed subsection149(1.2) could apply.

July 21, 2010

XXXXXXXXXX Tax Services Office
Attention: XXXXXXXXXXXX
cc : XXXXXXXXXXXX

HEADQUARTERS
Income Tax Rulings
Directorate
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2009-031186

XXXXXXXXXX -Management Fees Paid by XXXXXXXXXXXX

This is in response to a letter we received from XXXXXXXXXXXX , Team Leader -Technical Advisors dated February 19, 2009. We also acknowledge receipt of the additional information XXXXXXXXXXXX sent to us on May 18, 2010,

which included the package of materials from the taxpayer's representative.

In his letter, XXXXXXXXXXXX requested our views on the following:

1. The application of paragraph 149(1)(c) of the Income Tax Act (the "Act") to the XXXXXXXXXXXX (the "First Nation");
2. The taxation of management fees paid by the XXXXXXXXXXXX (the "Corporation") to the First Nation; and
3. Whether the Corporation qualifies for the exemption from tax provided by proposed paragraph 149(1)(d.5) of the Act.

FACTS

Based on the information sent to us, these are the facts as we understand them:

- * The First Nation claims that it is exempt from tax pursuant to paragraph 149(1)(c) of the Act.
- * The First Nation has passed by-laws under both sections 81 and 83 of the Indian Act.
- * The First Nation provides the following services to its members:
 - o water and sewer services;
 - o health services;
 - o housing;
 - o education;
 - o public daycare services and access;
 - o economic development;
 - o environmental services;
 - o consultation services;
 - o social development;
 - o elder care; and
 - o property tax collection.

* All the shares of the Corporation are held in trust by the Chief and Council of the First Nation for the benefit of the First Nation.

* The Corporation earns most of its income by providing services to companies involved in the XXXXXXXXXXXX .

* The Corporation is involved mainly in XXXXXXXXXXXX . In addition, the Corporation uses its equipment on the reserve to maintain XXXXXXXXXXXX and for general upkeep.

* Over 95% of the Corporation's revenue is related to services that are provided on land that is not a reserve.

* The Corporation operates out of the band office which is located on the First Nation's reserve.

* The majority of the Corporation's employees are Indians as defined in section 2 of the Indian Act.

* The financial statements for the Corporation show net income for the years XXXXXXXXXXXX and XXXXXXXXXXXX , but that net income is reduced to nil by means of an entry recording management fees paid to the First Nation. In XXXXXXXXXXXX the amount of management fees paid to the First Nation was \$XXXXXXXXXX and in XXXXXXXXXXXX the payment was \$XXXXXXXXXX . The XXXXXXXXXXXX and XXXXXXXXXXXX taxation years each had a loss.

* The Corporation claims that its income is earned from activities undertaken on "traditional land" of the First Nation such that it qualifies for an exemption from tax under proposed paragraph 149(1)(d.5) of the Act.

ANALYSIS

XXXXXXXXXX -Public Body Performing a Function of Government

Paragraph 149(1)(c) of the Act provides an exemption from tax on the taxable income of a municipality or public body performing a function of government. As the courts have determined that an Indian band cannot be a municipality, an Indian band would have to qualify as a public body performing a function of government in order to rely on the paragraph 149(1)(c) tax exemption.

The term "public body", as used in paragraph 149(1)(c) of the Act, is not defined, and thus we must consider on the general usage of this term. Generally, the CRA has accepted that Indian bands or Indian organizations that clearly provide government services and are accountable to either the federal, or a provincial or territorial government, or directly to the band members they represent (e.g., via elections), are public bodies.

In addition to being a public body, an Indian band must also perform a "function of government" in order to qualify for the exemption from tax provided by paragraph 149(1)(c) of the Act. Again, the term "function of

government" is not defined in the Act and reference must be made to the ordinary usage of this term. Generally, a government taxes its residents and sets laws for the orderly management of the area over which it has jurisdiction. As part of managing the area, the government offers a wide variety of services. It is important to note that any particular service provided by a government is not necessarily equivalent to a "function of government".

Our Directorate has accepted that providing municipal-type services, such as water, sewage removal, the pick-up of garbage and the maintenance of infrastructure such as roads, sewers and public buildings is a function of government. Further, providing a key service traditionally offered by the provinces or territories such as social services, overseeing of the environment, health services, or education is generally considered to constitute performing a function of government. Our Directorate has acknowledged that an Indian band providing health services pursuant to a "Health Transfer Agreement", in which several health-related services are transferred from Her Majesty the Queen to the Indian band, is performing a function of government. Our Directorate also accepts that negotiating a treaty with the federal government, or a provincial or territorial government, is a function of government.

Indian bands are granted the authority under the Indian Act to pass by-laws regulating the activities of members on a reserve (section 81 by-laws), as well as property tax by-laws affecting a reserve (section 83 by-laws). These by-laws must be approved by the Minister of Indian and Northern Affairs. As sections 81 and 83 of the Indian Act give an Indian band similar law-making authority to a municipality, our Directorate accepts that an Indian band that has passed section 81 and 83 by-laws pursuant to the Indian Act is a public body providing a function of government. As the First Nation has passed by-laws under both sections 81 and 83 of the Indian Act, and these by-laws have been approved by the Minister of Indian and Northern Affairs we accept that the First Nation is a public body performing a function of government.

We note that the section 83 by-law appears to have been passed in XXXXXXXXXXXX, and approved by the Minister of Indian and Northern Affairs in XXXXXXXXXXXX. Thus for years prior to XXXXXXXXXXXX reference should be made to the governance operations of the First Nation, and to the services and activities it provided to its members, in order to confirm that it met the requirements to be a public body performing a function of government under paragraph 149(1)(c) of the Act for those years. Based on the information provided to us, it is our view that the services provided by the First Nation to its members support the view that the First Nation is performing a function of government. You need to confirm that these services were provided for the years prior to XXXXXXXXXXXX in order to determine if the First Nation was a public body performing a function of government for those years.

Management Fees

The Corporation has been paying management fees to the First Nation in years in which the Corporation has had taxable income. Based on the

information provided, the fees were not paid pursuant to a written contract between the Corporation and the First Nation. The amount of the fees has varied over the years, yet the result has been consistent-the payment reduces the income of the Corporation to nil or puts the Corporation in a loss position. XXXXXXXXXX .

The Corporation may believe that it comes within the CRA's policy with respect to the payment of amounts to owner/shareholders by Canadian controlled private corporations ("CCPCs"). Under this policy, the CRA allows CCPCs to pay out income in the form of management fees to owner/shareholders, and to take a deduction for such payments, without CRA questioning the quantum of the fees, if certain criteria are met. The criteria include:

- * payments must be made to an individual owner/shareholder of the corporation;
- * the owner/shareholder must have been actively involved in the business;
- * the income paid must be a result of ordinary business operations; and
- * the owner/shareholder must be a Canadian resident who will include the amount received in income for income tax purposes.

The payment of management fees by the Corporation to the First Nation is not covered by the owner/shareholder remuneration policy described above, as the management fees are being paid to an Indian band and not to an individual owner/shareholder. Moreover, the policy contemplates that tax will be paid in Canada on the amount paid to the owner/shareholder; for example, the policy does not apply to non-resident shareholders. The policy was not intended to provide a reduction or elimination of taxes, but rather to allow for appropriate tax integration and to acknowledge the role of the individual owner/shareholder.

As the policy does not apply to the payment of management fees from the Corporation to the First Nation, you should review these payments and consider whether the amounts are reasonable in the circumstances. In our view, the management fees should reflect the value of the services provided to the Corporation by the First Nation, XXXXXXXXXX .

(iii) Application of Proposed Paragraph 149(1)(d.5) to the Corporation

The Act contemplates municipalities or public bodies (paragraph 149(1)(c) entities) establishing subsidiary organizations, and provides a specific exemption from tax for such subsidiaries, with restrictions. Proposed paragraph 149(1)(d.5) of the Act contains an exemption for corporations, commissions and associations, where not less than 90% of the capital is owned by a municipality or public body, provided that not more than 10% of the income of the corporation, commission or association is earned from

activities carried on outside the geographical boundaries of the municipality or public body.

Proposed paragraph 149(11) of the Act defines the geographical boundaries of a paragraph 149(1) (c) entity to be either:

"...(a) the geographical boundaries that encompass the area in respect of which an Act of Parliament or an agreement given effect by an Act of Parliament recognizes or grants to the body a power to impose taxes; or

(b) if paragraph (a) does not apply, the geographical boundaries within which that body has been authorized by the laws of Canada or a province to exercise that function..."

Generally, the geographical boundaries of an Indian band are the boundaries of either its reserve or lands transferred to it pursuant to a land settlement agreement or self-government agreement.

The existence of proposed paragraph 149(1) (d.5) suggests that the scheme of the Act is to exempt a public body performing a function of government from tax under paragraph 149(1) (c) of the Act, and to exempt subsidiaries of such a body under proposed paragraph 149(1) (d.5) of the Act (where certain conditions are met). The Act clearly contemplates that subsidiaries of paragraph 149(1) (c) entities will not necessarily themselves be paragraph 149(1) (c) entities.

In the situation you have described, the Corporation is 100% owned by the First Nation. Thus, the Corporation meets the ownership requirements necessary to qualify for the exemption from tax provided under proposed paragraph 149(1) (d.5) of the Act. However, you advise that most of the income earned by the Corporation was earned from activities carried out on land that is not a reserve. This means that the Corporation earned more than 10% of its income from activities carried on outside the geographical boundaries of the First Nation. If you confirm that this is the case, then the Corporation will not qualify for the tax exemption. The geographical boundaries of the First Nation are the boundaries of its reserve; the term "reserve" has a defined meaning in the Indian Act which, generally, is land set aside for the use and benefit of a band. Traditional lands of a First Nation do not meet the definition of "reserve". Thus, when determining the amount of income earned from activities carried on outside the geographical boundaries of the First Nation, all income earned from activities carried out on traditional land that is not part of the First Nation's reserve is included.

We draw your attention to proposed subsection 149(1.2) of the Act. This proposed subsection provides that the income earned by a 149(1) (d.5) entity outside the geographical boundaries of its parent entity (i.e., in considering the 10% limit discussed above) does not include certain income where:

- o the income is a result of activities carried on under an agreement in writing between the corporation, commission or association and Her

Majesty in Right of Canada, or a Province or a municipal or public body or corporation to which paragraphs 149(1) (d) to 149(1) (d.6) applies; and

o the activities are carried out within the geographical boundaries of the entity described in the above bullet.

Thus, it is important to determine whether the Corporation has entered into any contracts with one or more of the federal, provincial or territorial governments or a municipality or a federal, provincial or territorial crown corporation. If there are such contracts, then the Corporation could meet the requirements to be exempt from tax under proposed paragraph 149(1) (d.5) in certain tax years. If you have questions regarding the application of proposed subsection 149(1.2) please feel free to contact us.

CONCLUSION

We can confirm that the First Nation has been a public body performing a function of government since XXXXXXXXXXXX as it has passed by-laws under sections 81 and 83 of the Indian Act. For years prior to this, you will need to confirm the type of services the First Nation provided to its members and whether any of these, or all of them together, amounted to the First Nation performing a function of government. Based on the limited information provided to us by the taxpayer's representative, it is likely that the First Nation met the conditions of paragraph 149(1) (c) of the Act prior to XXXXXXXXXXXX , however, you will need to confirm that the services described were actually provided to members of the band and for what years.

The policy with respect to the payment of management fees to owner/shareholders does not apply to the payments made by the Corporation to the First Nation. Thus, the payment of these amounts should be reviewed and it should be determined whether the amounts were reasonable based on the services provided.

Finally, based on the limited information provided, it is our view that the Corporation likely does not qualify for the tax exemption provided by proposed paragraph 149(1) (d.5) of the Act. Most of the income earned by the Corporation appears to arise from activities carried on outside the geographical boundaries of the First Nation. It does not matter that the location where the income-earning activities took place was part of the "traditional land" of the First Nation. Because the First Nation has a reserve, the boundaries of the reserve determine the geographical boundaries of the First Nation for purposes of proposed paragraph 149(1) (d.5). However, it is not clear to us, based on the information provided, whether proposed subsection 149(1.2) of the Act could apply. XXXXXXXXXXXX .

We trust that these comments will be of assistance. If you have any further questions once you have completed your audit please feel free to contact us again.

For your information, unless exempted, a copy of this memorandum will be severed using the Access to Information Act criteria and placed in the Canada Revenue Agency's electronic library. A severed copy will also be distributed to the commercial tax publishers for inclusion in their databases. The severing process will remove all material that is not subject to disclosure, including information that could disclose the identity of the taxpayer. Should the taxpayer request a copy of this memorandum, they may request a severed copy using the Privacy Act criteria, which does not remove taxpayer identity. Requests for this latter version should be made by you to Mrs. Celine Charbonneau at (613) 957-2137. In such cases, a copy will be sent to you for delivery to the taxpayer.

Eliza Erskine
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