ARTICLE

INDIGENOUS SETTLEMENT TRUSTS: RECHARACTERIZING THE NATURE OF TAXATION

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CITED: (2019) 24 *Appeal* 3

ABSTRACT

This article examines how Indigenous Settlement Trusts ("Settlement Trusts"), established for the benefit of First Nations, are affected by the *Income Tax Act* ("*Tax Act*"). I argue that Settlement Trusts should be taxed differently than other personal trusts under the *Tax Act.* Currently, a Settlement Trust is taxed just as any other trust—as an individual pursuant to section 104(2) of the *Tax Act*—regardless of whether distinguished circumstances exist, as in the case of *Indian Act*-recognized Bands. This means that revenues are taxed at the top personal marginal tax rate. As such, the Settlement Trust relies upon the application of section 75(2) of the *Tax Act* to attribute revenues that remain in the Trust to the Band. The revenues are then tax exempt, pursuant to section 149(1)(c) of the *Tax Act*, because the Canada Revenue Agency's administrative position is that Bands are public bodies performing a function of government in Canada. Ultimately, Bands face unnecessary administrative processes and costs from having Settlement Trusts taxed in this manner. I conclude that the Federal government should amend the *Tax Act* to exempt Settlement Trust revenues from being taxed under the general trust tax provisions so that administrative costs and processes for Bands will be eliminated or at least minimized. Bands could then claim Settlement Trust revenues directly in the same manner that they claim all other Band revenues.

INTRODUCTION

Historically, Indigenous people's participation in economic and commercial activities was an integral part of traditional Indigenous governance practices. Thus, participation in economic activities is not a new concept for Indigenous peoples. In fact, activities that yielded economic benefits flowed from Indigenous self-determination and self-governance. Participation in contemporary commercial activities means that Indigenous people may hold property in various modern forms.

This article discusses how Bands, through participation in the mainstream economy, may acquire and hold property through the use of investment structures related to Settlement Trusts. When Bands receive compensation funds from Settlement Agreements, a means

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is required to manage those funds. Trusts have existed for hundreds of years and have become an increasingly more common fiscal management and investment instrument for Bands. However, a Band's use of Settlement Trusts as a means of fiscal management is not without challenges. This article discusses these challenges.

It should be noted here that very little academic scholarship exists on the topic of Indigenous Settlement Trusts. Therefore, in order to meaningfully contribute to legal discourse in this area, this article aims to highlight the legal and taxation issues surrounding these Trusts. This is the beginning of the discussion, but it cannot be the end. Trusts are important fiscal management vehicles for Bands. Therefore, they must be carefully considered as unique and viable mechanisms to increase wealth in Indigenous communities. The goal of this discourse is to prompt further legal discussion around these unique trust structures for Indigenous peoples.

It should also be noted that Indigenous communities in Canada are diverse and their infrastructures vary depending on the community. Therefore, the trust and tax issues discussed here may not apply to all communities. For instance, *Indian Act*-recognized Bands that have trust administration offices on reserve do not have the same taxation issues. Further, not all Indigenous communities in Canada are *Indian Act*-recognized Bands, as defined in the *Act*. In those cases, the qualification for tax exemption under section 149(1)(c) of the *Income Tax Act* ("*Tax Act*") may not be available currently because these communities are not interpreted by the Canada Revenue Agency as "public bodies performing a function of government in Canada."[1] Lastly, Trust agreements are also as varied as the communities that enact them. Given these limitations, this paper is meant to provide background and address, in a general sense, some of the trust administration issues that are problematic for some Bands.

In Part I, the history and nature of trusts as creatures of equity is considered. This section also provides the context in which a Band uses a Settlement Trust as a means to manage settlement funds. To set the backdrop for the tax-related issues discussed in the rest of this paper, Part II will discuss the taxation of trusts more generally under the *Tax Act*.[2] This part will also consider how this applies to Settlement Trusts, regardless of their unique nature. Then, in Part III, some of the administrative challenges experienced by Bands due to the application of the general trust tax provisions to Settlement Trust revenues is discussed. Finally, in Part IV, a viable solution in the form of an amendment to the *Tax Act* is considered. The proposed amendment could minimize or eliminate unnecessary administrative processes related to the current manner that Settlement Trusts are taxed under the *Tax Act*.

I conclude that current legislation related to the taxation of Settlement Trusts is problematic because the Trust is required to take advantage of section 75(2) of the *Tax Act* to attribute revenues to the Band to qualify for tax exemption. This carries with it some unnecessary administrative processes and costs for the Band. In fact, both the Settlement Trust and the Canada Revenue Agency are burdened with unnecessary administrative processes that could easily be minimized or eliminated completely by amending the *Tax Act* to exclude Settlement Trusts from being taxed under the general trust provisions. The Band could then claim Settlement Trust revenues directly under section 149(1)(c) of the *Tax Act* (absent the need for section 75(2)).[3]

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1 RSC, 1970, c I-6 (now RSC, 1985, c I-5) [*Tax Act*].

2 *Ibid*.

3 *Ibid*, s 149(1)(c).

149(1) No tax is payable under this Part on the taxable income of a person for a period when that person was (c) a municipality in Canada, or a municipal or public body performing a function of government in Canada.

I. THE NATURE OF INDIGENOUS SETTLEMENT TRUSTS

Express trusts are intentional trusts created for the benefit of persons.[4] The practice of holding trusts dates back over six hundred years and its original purpose was as a legal "use."[5] Legally, a party, the trustee, holds property in trust for the use and benefit of another party, the beneficiary.[6] As such, trusts are a valuable conduit for control and ownership of property.[7] The trust concept is defined in the following manner:

> A trust is an equitable obligation, binding a person (called a trustee) to deal with property (called trust property) owned by him as a separate fund, distinct from his own private property, for the benefit of persons (called beneficiaries, or, in old cases, *cestuis que trust*), of whom he may himself be one, and any one of whom may enforce the obligation.[8]

Notably, a trust is not an entity, but rather a "*relationship* involving obligations owed by the person who holds the trust property." [9] As such, the trust does not hold property; instead, the trustee holds property in trust for the benefit of another party. It is against this backdrop that the nature of Settlement Trusts is considered in this article.

A Settlement Trust is an express private trust that is intentionally created by a Band as a means to hold assets that result from Settlement Agreements. Holding settlement funds in trust is a means through which Bands participate in the commercial financial economy as settlement funds are managed and invested in the securities market to yield income from these investments. Therefore, such structures may be considered fiscal management vehicles that yield investment returns to be used for the overall maintenance and development of the Indigenous community (the Band) subject to the trust terms. The use of a trust has significant implications for Bands in that a trust facilitates critical financial planning as well as ensures that funds are directed to the beneficiary of the trust. It is therefore a viable conduit that provides the Band with a flexible means for the disposition of settlement assets that will, in the long-term, benefit the community members.

Settlement Trusts are established with settlement monies awarded to Indigenous peoples as a redress for past, present and future adverse impacts upon Indigenous land rights caused by government or third parties.[10] The form of these settlement monies is dependent upon

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4 See e.g. David Hayton & Paul Matthews, *Underhill and Hayton Law Relating to Trusts and Trustees*, 18th ed (London: LexisNexis, 2010) at 79-80; Geraint Thomas & Alastair Hudson, *The Law of Trusts*, 2nd ed (Oxford: Oxford University Press, 2010) at 19; Jill E Martin & Harold G Hanbury, *Modern Equity*, 19th ed (London: Thomson, Sweet & Maxwell, 2012) at 71; Eileen E Gillese, *The Law of Trusts*, 3rd ed (Toronto: Irwin Law, 2014) at 39; and Albert H Oosterhoff, Robert Chambers & Mitchell McInnes, *Oosterhoff on Trusts: Text, Commentary and Materials*, 8th ed (Toronto: Carswell, 2014) at 24 [Oosterhoff]; Donovan Waters, ed, *Waters' Law of Trusts in Canada,* 4th ed (Toronto: Thomson Reuters, 2012) at 19.

5 Dennis Pavlich, *Trusts in Common-Law Canada,* 2nd ed (Toronto: LexisNexis, 2016) at 32. See also e.g. Oosterhoff*, supra* note 4 at 8; Waters, supra note 4 at 6.

6 Eileen E. Gillese and Martha Milczynski, *The Law of Trusts,* 2nd ed (Toronto: Irwin Law, 2005) at 5. See also e.g. Oosterhoff*, supra* note 4 at 8; Pavlich*, supra* note 5 at 5.

7 See e.g. Oosterhoff, *supra* note 4 at 10; Waters*, supra* note 4 at 3; Pavlich, *supra* note 5 at 6. Trust property should be dealt with in such a manner so as to ensure the preservation of benefits for the beneficiary of the trust.

8 See e.g. Oosterhoff, *supra* note 4 at 18.

9 See e.g. Oosterhoff, *supra* note 4 at 18 [emphasis in original]; Pavlich*, supra* note 5 at 4; Waters*, supra* note 4 at 3; Gillese and Milczynski*, supra* note 6 at 5.

10 William H. Cooper, "The Essentials of First Nation Settlement Trusts" (Presentation delivered at the Aboriginal Financial Officers Association Annual General Meeting, Halifax, February 2014), [unpublished].

the terms of the agreements entered into between a Band and either Canada, the province or another third party, such as an industry proponent. Agreements vary based upon the type of claim advanced and the party toward whom the claim is directed.

The agreement leading to the creation of a Settlement Trust may be the result of a Treaty claim or some other type of claim. Treaty claims—including Treaty Land Entitlement claims, Treaty Annuity claims, Railway claims, or Agricultural Benefit Claims—are asserted when the Crown is alleged to have not honoured certain terms of a Treaty with the relevant Band. A federal specific claims process has been established for Treaty claims under $150,000,000 in an attempt to resolve these claims in as expeditious and judicious a manner as possible.[11] In the case of non-Treaty claims, agreements may be the result of negotiations with the province or industry partners who compensate Bands for taking up business on reserved lands.

Funds resulting from resolved claims are deposited into a Settlement Trust account with certain terms dictating the allocation of assets or returns. Other sources of Band revenues, such as business revenues, may also be deposited from time to time. While the property is held in trust by the trustee for the beneficiary, the Band, it shall only be distributed under such terms as the trust indenture allows. It is incumbent upon the trustee, acting in a fiduciary capacity, to contemplate the terms of the trust and relevant trust law when receiving instruction in relation to the investment or transfer of trust property, including income distribution.[12]

The strategic management of settlement funds empowers Bands in areas of economic support, community development and the long-term sustainability of the community for generations to come. Because Settlement Trust terms are specific to each community's precise needs and individual circumstances, the trust terms are drafted with the long-term future of that community in mind. The Band, with its potential political disruption every few years and in some instances a lack of infrastructure within the community, may not have the systems in place to manage settlement funds for long-term use.[13] Thus, Settlement Trusts are a suitable and common financial management vehicle for the investment and management of such capital. The next section will discuss the nature of the taxation of Settlement Trusts.

II. THE TAXATION OF INDIGENOUS SETTLEMENT TRUSTS

Although Settlement Trusts may be a feasible market-based approach to manage Indigenous treasury, certain challenges exist in relation to the taxation of Settlement Trust revenues as compared to the taxation of other Band revenues. This section will first review the general trust tax rules in the *Tax Act* and then provide an overview of the current tax treatment of Settlement Trust income and the relevant *Tax Act* provisions.

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11 The Specific Claims Tribunal was established on October 16, 2008 to further the resolution of specific claims made against the Crown for a breach of Treaty obligations and administration of land and other First Nation assets. The goal is to provide justice for First Nation claimants and more certainty for government, industry and the rest of Canada. See the Tribunal, online: Specific Claims Tribunal Canada, http:www.sct-trp.ca [Tribunal].

12 See e.g. Trustee Act 2009, SS 2009, c T-23.01, s 7 [Trustee Act]. Adhering to trust terms is critical for the long-term management of trust assets. For instance, many Settlement Trusts do not permit encroachment upon capital, thus, capital must remain in the trust to be invested for the benefit of future generations.

13 Cooper, *supra* note 10.

A. General Trust Tax Treatment

Income earned by a trust is taxable in that trusts are taxed as individuals under section 104(2) of the *Tax Act*.[14] Pursuant to section 248(1) of the *Tax Act*, an individual is deemed to be anyone other than a corporation.[15] While taxing the trust is similar to how an individual is taxed, a trust is, in effect, a fictional individual.[16] However, unlike individuals, a trust is not eligible for personal credits because of individual circumstances.[17]

Although trusts are taxed as individuals and would normally be taxed pursuant to the prescribed rates in section 117(2) of the *Tax Act*, an exception exists for *inter vivos* trusts.[18] The consequence of this exception is that the trust is taxed at the *top personal marginal tax rate,* pursuant to section 122(1) of the *Tax Act*.[19] Trust revenues remaining in the trust are taxed to the trust, and those paid out of the trust in that particular fiscal year are taxed to the beneficiary, pursuant to section 104(13) of the *Tax Act.*[20] When income from the trust is paid out, or entitled to be paid out,[21] to the beneficiary in a given taxation year, that income is added to the beneficiary's total income for the fiscal year and tax owing is then calculated based upon that total taxable income, pursuant to section 12(1) of the *Tax Act*.[22] The trust can then deduct the amounts paid to the beneficiary in calculating its taxable income, pursuant to section 104(6)(a.2) of the *Tax Act*.[23] The next section will discuss the application of these tax rules to Settlement Trust revenues and how the application of other tax mechanisms are necessary to garner tax-exempt status for Settlement Trust revenues that remain in the trust.

B. Applying the Tax Rules to Settlement Trusts

Regardless of the fact that settled assets in a Settlement Trust result from settlements between the Crown and the Band, in most cases, or from other agreements between the Band and third parties, in other cases, revenues from these trusts are taxed just as any other trust under the general trust tax provisions. As previously mentioned, trusts are not eligible for tax credits due to personal circumstances under the *Tax Act*. In order for a Band to qualify for tax exemption on this income, Settlement Trust revenues must be connected to the Band in such a way so that *Indian Act* or *Tax Act* exemptions apply. An attribution rule that attributes revenues to the tax-exempt Band will accomplish this. The

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14 *Tax Act*, *supra* note 1, s 104(2).

104(2) A trust shall, for the purposes of this Act, and without affecting the liability of the trustee or legal representative for that person's own income tax, be deemed to be in respect of the trust property an individual […].

15 *Ibid,* s 248(1).

16 Jinyan Li, Joanne Magee and J. Scott Wilkie, *Principles of Canadian Income Tax Law*, 9th ed (Carswell: Toronto, 2017) at 437 [Li et al].

17 *Tax Act, supra* note 1, s 122(1.1).

18 *Ibid,* s 117(2).

19 *Ibid,* s 122(1) [emphasis added]. This rate is 33%. However, it is grossed up by the applicable provincial rate to ascertain the combined federal-provincial rate. As such, it can be as high as 54% depending upon the jurisdiction. For a review of the 2018 top personal marginal tax rates by province see:

BDO Canada LLP, https://www.bdo.ca/BDO/media/Misc-Documents/2018-Top-Personal-Marginal-Income-Tax Rates_v2018-02-08.pdf *(retrieved on August 24, 2018) archived at* <https://perma.cc/35YW-GHA6>.

20 *Tax Act, supra* note 1, s 104(13).

21 A promissory note could also be issued for the accrued income. Promissory notes are defined under the *Bills of Exchange Act*, RSC, 1985, c B-4, s 176(1) [*Exchange Act*]. The amount of the promissory note is to be included in the bearer's taxable income, pursuant to section 12(1)(b) of the *Tax Act*.

22 *Tax Act, supra* note 1, s 12(1).

23 *Ibid,* s 104(6)(a.2).

purpose for which attribution provisions were created and the application of the attribution rule, section 75(2), to Settlement Trust revenues will be discussed in the next sections.

i. Tax Attribution Rules

Under the *Tax Act*, the general rule of income taxation is that all recognized sources of the taxpayer's income are considered, from which taxes are then calculated.[24] As discussed earlier, the *Tax Act* imposes taxes based upon a progressive rate structure, pursuant to section 117(2). Under the progressive rate structure, the Canada Revenue Agency calculates the percentage of tax within each tax bracket up to the total of the last dollar earned, and from those figures computes the average or effective amount for the overall tax amount owed.[25] However, as it relates to trusts, an *inter vivos* trust is taxed at the top personal marginal tax rate. The *Tax Act* contains certain anti-avoidance mechanisms to prevent a taxpayer from avoiding tax by, for example, attempting to split income as a way to lower his or her overall progressive tax rate.[26] In essence, the overall objective of income splitting is to avoid tax and anti-avoidance provisions seek to prevent that.[27]

Before delving into why this is relevant for Bands, the question of "whose income is it?" should be considered. Typically, "[i]ncome is taxed to the person who earns and receives it, by providing personal services as an employee, by carrying on a business, or by virtue of owning property."[28] Taxpayers who attempt to shift or avoid tax liability undermine the fairness and integrity (fundamental notions of tax policy) of the tax system by manipulating events to achieve a tax deduction or reduction.[29] This also applies to the taxation of trusts; as indicated, trusts are taxed as individuals and tax liability rests with the trust as an individual taxpayer.

In the case of a Settlement Trust, if income is paid out to the Band annually, issues around taxation are non-existent because the Band is a tax-exempt body under section 149(1)(c) of the *Tax Act*.[30] Thus, when a Band receives a T3 for any fiscal year it simply ignores it as it is not required to pay tax. However, if the income remains in the trust, the Settlement Trust must rely upon the application of an attribution rule to qualify for tax exemption. This attribution rule is discussed in the next section.

ii. Application of Attribution Rules to Settlement Trusts

To prevent tax avoidance, the *Tax Act* contains specific attribution provisions that apply under specific taxpayer's circumstances.[31] In the case of trusts, section 75(2) is the attribution provision that applies to trust income to prevent taxpayers from avoiding tax on trust income; this provision is reproduced below:

> 75(2) If a trust, that is resident in Canada and that was created in any manner whatever since 1934, holds property on condition:

24 *Ibid*, s 3(a).

25 Li et al, *supra* note 16 at 433-4.

26 David G. Duff, (1999) "Neuman and Beyond: Income Splitting, Tax Avoidance, and Statutory Interpretation in the Supreme Court of Canada" 32 Can Bus LJ 345 at 346 [Duff]; Tim Edgar, Arthur Cockfield and Martha O'Brien, *Materials on Canadian Income Tax 15th Edition* (Carswell: Toronto, 2015) at 111 [Edgar et al].

27 See e.g. *Tax Act, supra* note 1, s 56(2), s 75(2), 74.1(1), 74.1(2), 74.2. For a more thorough discussion on anti-avoidance provisions see *Li et al, supra* note 16 at 398; *Edgar, supra* note 26 at 111-2.

28 Li et al, *supra* note 16 at 393.

29 *Ibid* at 398.

30 Louis Tapper, Chartered Professional Account, MNP LLP Canada, (February 25, 2018) [*MNP*]. MNP is an accounting firm that prepares Settlement Trust audits and tax returns on behalf of its Indigenous clients.

31 Edgar et al, *supra* note 26 at 111.

> (a) that it or property substituted therefore may
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> > (i) revert to the person from whom the property or property for which it was substituted was directly or indirectly received (in this subsection referred to as "the person"), or
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> > (ii) pass to persons to be determined by the person at a time subsequent to the creation of the trust,or
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> (b) that, during the existence of the person, the property shall not be disposed of except with the person's consent or in accordance with the person's direction, any income or loss from the property or from property substituted for the property, and any taxable capital gain or allowable capital loss from the disposition of the property or of property substituted for the property, shall, during the existence of the person while the person is resident in Canada, be deemed to be income or a loss, as the case may be, or a taxable capital gain or allowable capital loss, as the case may be, of the person.[32]

Generally, section 75(2) is meant to apply when certain conditions exist. First, the trust must be created and resident in Canada. Next, after trust creation, the trust property (or substituted property) may revert back to the settlor or a person determined by the settlor, or the settlor may consent or direct the disposition of the property. In other words, if a settlor settles property onto the trust and retains control over the property and/or is the beneficiary of the trust property, section 75(2) is applicable.

In *Sommerer v The Queen*, the Federal Court of Appeal interpreted this provision to determine the circumstances in which section 75(2) applies.[33] The Court found that in analyzing those circumstances, a purposive interpretation must be undertaken to give effect to its application.[34] In the facts of *Sommerer*, a father, located in Austria, registered a private foundation, settled assets into it and designated his son and family, located in Canada, as the beneficiaries.[35] While the assets were settled into and administered by the foundation in Austria, the beneficiary son resided in Canada at all times.[36]

The son, Mr. Sommerer, eventually sold certain shares to the foundation and when the foundation sold the shares it realized capital gains on the sale.[37] The Minister took the position that the capital gains realized by the foundation on the sale of the shares were attributable to the beneficiary son. The beneficiary son was considered by the Minister to be the contributor of the funds, via the shares, pursuant to section 75(2) of the *Tax Act.* Mr. Sommerer successfully appealed the Minister's tax reassessment to the Tax Court of Canada and the Minister appealed to the Federal Court of Appeal.

The Federal Court of Appeal upheld the Tax Court's decision on the basis that if fair market value dispositions[38] were caught by section 75(2), absurd consequences would ensue that could not have been intended by Parliament.[39] Two parties could end up being

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32 *Tax Act, supra* note 1, s 75(2).

33 2012 FCA 207, [2012] DTC 5126 [*Sommerer*].

34 *Ibid* at para 48.

35 *Ibid* at paras 20-22.

36 *Ibid* at para 19.

37 *Ibid* at para 30.

38 A fair market value disposition would mean that Mr. Sommerer sold the shares to the foundation for fair market value. The foundation must then claim all accrued capital gains and losses for taxation purposes.

39 *Sommerer, supra* note 33 at para 49.

taxed on a disposition by the trust; that is, the original settlor and the beneficiary, who contributed property by way of fair market value dispositions into the trust.[40] The idea of double taxation does not make sense because the text of section 75(2) indicates that the person who contributes property to the trust either directly or indirectly is the person in which gains, or losses, should be attributed. A trust is only legally valid after a settlor constitutes the trust via the initial property settlement with the trustee. Therefore, it makes sense that at the creation of the trust is the time in which the settlor is determined because that is the point in time in which the original property is situated into the trust and the trust is legally constituted.

As such, the Federal Court of Appeal found that if a trust is created when property is received from the settlor, then only the settlor could be "the person" who subsequently determines who the property passes to, pursuant to section 75(2)(*a*)(i).[41] Therefore, a finding was made that the Minister erred in assessing tax to the beneficiary son. While fair market dispositions are not at issue in the case of Settlement Trusts, the *Sommerer* decision is relevant in terms of informing who the "person" is as the settlor of trust property. In this case, the settlor "person" is the Band because the Band is the party that initially settles property to create the trust.

The Federal Court of Appeal also considered the language of section 75(2) as it related to the term "reversion." A settlor who has the right to determine the disposition of the trust property, is considered to have the right of reversion for that property.[42] Under section 75(2) the settlor cannot avoid income tax on property, contributed by him or her, that may return or revert to the settlor at some future date.[43]

Finally, the Federal Court of Appeal considered the overall purpose of section 75(2) and a common circumstance in which it applies:

> [S]ubsection 75(2) generally is intended to ensure that a taxpayer cannot avoid the income tax consequences of the use or disposition of property by transferring it to another person in trust while retaining a right of reversion or a right of disposition with respect to the property or property for which it may be substituted. A common example of the application of subsection 75(2) is the settlement of a trust where *the settlor is also a beneficiary* with an immediate or contingent right to a distribution of the trust property. In that situation, and in many other situations contemplated by paragraphs 75(2)(a) and (b), subsection 75(2) achieves its intended purpose.[44]

Recall that a Settlement Trust is created when the Band, the settlor, deposits settlement assets into the trust for the benefit of the Band, the beneficiary. The Band, as settlor, is the "person" who determines to whom the property passes under the terms of the Settlement Trust. The Band is also the beneficiary of the Settlement Trust assets because the very purpose of creating a Settlement Trust is for the long-term benefit of Band members. Therefore, the Settlement Trust property will revert to the Band at a future date. If the certain conditions under section 75(2) are met, income is deemed to be attributed to the settlor Band for tax purposes.

40 *Ibid* at para 55.
41 *Ibid* at para 57.
42 *Ibid* at para 48.
43 *Ibid*.
44 *Ibid* [emphasis added].

Under these facts, the Band is indeed caught by the application of section 75(2) because the Band is both the settlor as well as the beneficiary and has the right to a distribution of the Settlement Trust property. In assessing tax on Settlement Trust revenues, income that remains in the trust and is not paid out, is attributed to the Band, pursuant to section 75(2) of the *Tax Act*.[45] The revenues then qualify for tax exemption as the Band is interpreted as a public body performing a function of government in Canada, regardless of the fact that the general objective of section 75(2) is to prevent tax avoidance, not promote it.

Arguably, it is incongruous that to qualify for tax-exemption, Settlement Trust revenues have to rely upon the application of section 75(2). In effect, the provision is being applied here contrary to its legislative purpose because typically the application of section 75(2) produces tax consequences for the settlor. As discussed in *Sommerer*, the purpose of section 75(2) is to prevent income splitting and while it cannot be said that the Band is "income splitting" per se, the application of section 75(2) to Settlement Trust revenues has a different effect than was intended by legislators.

The Settlement Trust's reliance on the application of section 75(2) to yield tax exemption creates unnecessary administrative processes as well. In the next section, I expand upon the application of this provision as a part of a review of some of the drawbacks for Bands related to the current tax treatment of Settlement Trusts.

III. SETTLEMENT TRUST TAX PROBLEMS FROM THE BAND'S PERSPECTIVE

Whether the application of section 75(2) is appropriate, from a policy perspective, in dealing with the taxation of Settlement Trust revenues is a matter of debate. However, its application in this context employs a kind of workaround that is a round-about way of usurping section 104(2) of the *Tax Act* such that the trust revenues, in effect, are not taxed. Arguably, section 104(2) of the *Tax Act* is overly broad in that it automatically includes Settlement Trusts and it appears that sufficient consideration was not given to whether Settlement Trusts should be taxed differently than other trust structures. As discussed, the current tax treatment causes the requirement of Settlement Trusts to rely upon the application of section 75(2) to gain tax-exempt status. Notwithstanding, Bands incur administrative burdens and costs because of its application (as compared to a more direct tax exemption in the *Tax Act*).

Rather than simply drafting the terms of a Settlement Trust with the *key objective of prioritizing community interests* in mind, Bands must consider the legal, administrative, and tax accounting mechanisms necessary to assist in managing tax considerations. Mostly, lawyers, consultants, accountants, trustees and tax experts benefit financially from this, and, conversely, Bands incur financial costs. Yet, under this construction these costs are necessary to ensure tax compliance through the application of section 75(2) so that income is attributed back to the non-taxable Band. Consequently, returns on settlement monies are then not eroded by income tax.

45 When the Settlement Trust tax return is filed, first generation income is attributed to the settlor Band, pursuant to section 75(2) of the *Tax Act*. If the Band is a public body performing a function of government in Canada, income earned is not taxable, pursuant to section 149(1)(c) of the *Tax Act*. Arguably, if section 75(2) applies to Settlement Trust income, the Settlement Trust should not be required to file a Trust Informational Return because it does not have income. Rather, the income is attributed as the Band's income. However, all trusts are required to file a tax return. Notably, the Band does not file tax returns for any of its other sources of income because it is tax exempt, pursuant to section 149(1)(c) of the *Tax Act*. Information obtained through discussions with Louis Tapper, Chartered Professional Account, MNP LLP Canada. *MNP, supra* note 30.

In fact, certain administrative efforts are necessary to distinguish a Settlement Trust so that section 75(2) applies. For instance, income from a general personal trust is still taxed either to the trust or to the beneficiary.[46] The key here is that the settlor, who may be a different person than the beneficiary, will typically want the income to be paid out to the beneficiary to be taxed in the beneficiary's hands, otherwise it will be taxed to the trust. Additionally, a general personal trust will last for the lifetime of the capital beneficiary because the trust terms are presumed to exist for the benefit of the beneficiaries.[47] Thus, trust assets are distributed out to the capital beneficiaries during their lifetime and at the time that the trust winds up or is considered terminated.

On the contrary, in order for a Settlement Trust to be caught by section 75(2) terms must be distinctly drafted so as to ensure that it is clear that the Band is *both the settlor and the beneficiary*. An example of these terms are reproduced below:

> [T]he Trustee acknowledges that the Compensation shall be deposited by or on behalf of the First Nation to the Trust Account. Any monies deposited or transferred to the Trust Account and accepted by the Trustee are *deemed to be contributed by the First Nation* and shall be added to the Trust Property and governed by the terms of this Agreement.
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> -and-
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> [T]he First Nation and the Trustee acknowledge that the *First Nation*, acting through its duly elected Chief and Council, *is the Beneficiary* of the Trust, with all of the rights and powers normally vested in a beneficiary to compel enforcement of the Trustee's duties under this Agreement.[48]

Note here that monies paid out by third parties (such as industry proponents) are *deemed* to be contributed to the Settlement Trust by the Band. This kind of deeming provision is required because to qualify for tax exemption as a public body, only the Band can be the settlor of the trust property (and income is then attributed to the Band through section 75(2)). Finally, to qualify for tax exemption, pursuant to section 149(1)(c), the beneficiaries must be the *collective* Band and not individual Band members.

Next, Settlement Trust terms should be clear that the property either can or will revert back to the settlor at some time either during the lifetime of the Band or upon termination of the trust, pursuant to section 75(2)(a)(i) of the *Tax Act*. The trust property cannot revert to individual Band members. The following Settlement Trust provision accomplishes this:

> [I]f this Trust is terminated by order of a court for any reason after the Compensation Date, the Trustee shall pay any outstanding amounts owing for Authorized Expenses forthwith and *shall transfer the remaining balance of the Trust Property to the First Nation*, or such other person or trustee as may be designated by Council.[49]

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46 Although there are different kinds of trusts, here I simply refer to an express trust for persons and not purposes, that is, a trust set up for the benefit of either individuals or corporate persons. For an express trust to be valid four requirements must be met: a) parties must have capacity to enter into a trust relationship; b) certainty of intention, subject-matter and objects of the trust must be clear; c) trust property must constituted by transferring the property to the trustee; and d) requisite formalities must be met. See *Oosterhoff*, *supra* note 4 at 24, 183; Mark R. Gillen and Faye Woodman, *The Law of Trusts, 3rd edition* (Emond Montgomery Publications Ltd: Toronto, 2015) at 70 [Gillen and Woodman].

47 Oosterhoff, *supra* note 4 at 40.

48 Redacted source of Settlement Trust clauses filed with author [emphasis added].

49 Redacted source of Settlement Trust clause filed with author [emphasis added].

Conversely, in the case of a personal trust, the winding up of a trust would cause the distribution of assets to go to individual beneficiaries, not typically the settlor.[50]

Provisions must also be drafted to ensure that annual income is paid (or owed) to the Band. Subsection 75(2) only applies to first-generation income, that is, the income that is earned from the investment of the initial assets of the Settlement Trust. This is because second-generation income is not deemed to be contributed by the settlor of a trust.[51] Therefore, in the first year, income can be attributed to the Band. Subsequently, if the income stays in the Settlement Trust the revenues earned on first-generation income (second-generation income) cannot be attributed to the Band. The following example explains the accumulation of second-generation income and how it is taxed:

> 1) Year One: The initial investment income earned is called first-generation income. If it remains in the trust it is attributed to the Band, pursuant to section 75(2), and is tax-exempt. Alternatively, if paid out to the Band, it is deducted from the Trust's income and taxed to the tax-exempt Band, pursuant to section 149(1)(c));
>
> 2) Year Two: First-generation income retained in the Settlement Trust in which income is earned is called second-generation income. Second generation income cannot be attributed to the Band because the Band is not considered as having contributed it to the Trust. Therefore, it must be tracked and paid out or a promissory note issued for its value. If paid out it will be deducted from the Trust's income and taxed to the tax-exempt Band, pursuant to section 149(1)(c); and
>
> 3) Year Three and Beyond: Income accumulating in the trust that was not previously paid out or a promissory note issued (third generation income) is not tax exempt and therefore must be tracked and paid out or a promissory note issued to achieve tax exemption.

It is clear then that Settlement Trust provisions must be explicit on the income that is getting distributed from the trust so that favourable tax treatment can be ensured. The following provisions relate to the payment of annual income from a Settlement Trust:

> [A]nnual Income" means all income for Canadian federal income tax purposes arising from the Trust Property in any Fiscal Year as determined in accordance with the *Income Tax Act* but without reference to subsection 104(6) of the *Income Tax Act*, including, but not limited to, interest, dividends and the taxable portion of the aggregate of the capital gains less the aggregate of the capital losses realized by the Trust during such Fiscal Year, and less all expenses and deductions eligible for Canadian federal income tax purposes.
>
> -and-
>
> [N]otwithstanding anything to the contrary in this Agreement, the Annual Income shall be deemed to be due and payable in its entirety to the

50 Beneficiaries are then responsible for tax consequences. A more practical understanding of drafting Settlement Trusts so that section 75(2) applies was obtained through conversations and interviews with Ms. Janice Vohrah, Director, Tax Advisory Group, RBC Taxation, Royal Bank of Canada and Jemison Jackson, Regional Vice President, British Columbia & Director, Aboriginal Trust Services, Royal Trust Corporation of Canada (July 2018).

51 Canada Revenue Agency, Ruling- 2010-0372531E5, "First Nation Land Claim Settlement Trust Income" (2010) [CRA Ruling].

> Beneficiary as at December 31 of each Fiscal Year and attributed as income to the Settlor pursuant to the application of subsection 75(2) of the *Income Tax Act*.[52]

It is certainly possible, and perhaps even probable, that a Settlement Trust could be drafted in this manner regardless of the tax implications. However, section 75(2) certainly would not apply without careful consideration of these key terms.

The management and administration of Settlement Trusts, drafted specifically to catch the application of section 75(2) in order to yield tax benefits, also comes with further administrative burdens. First, it is necessary to ensure that all of the Settlement Trust's tax-deductible expenses are taken into consideration in order to reduce the total taxable income in the trust. As such, this requires a tracking of relevant deductible expenses. As previously stated, section 75(2) only applies to first generation income so second-generation income is not considered income earned on property contributed by the settlor, the Band. Therefore, it will be taxable to the extent that it is not paid to the beneficiaries. Consequently, it is necessary to either track the lines of investment income in order to avoid the payment of taxes on second-generation income and ensure that all taxable income is paid out of the Settlement Trust each fiscal year or issue a promissory note for the revenues owing.

As it relates to promissory notes, these are defined under the Exchange Act as an "unconditional promise in writing made by one person to another person, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer."[53] A promissory note is recognized at law and is therefore enforceable as a legal demand. The Settlement Trust should contain provisions relating to promissory notes: first, to minimize the sum total of second-generation income; second, in the event that second-generation income does not get paid out of the trust, provisions must be made for this income. Examples of such terms are reproduced below:

> [I]n order to *avoid any adverse tax consequences*, the Trustee shall, in each Fiscal Year, distribute the Annual Payment, Special Loan Payments, Authorized Loan Payments, Legal Costs, and Authorized Expenses *firstly from any Secondary Income*, secondly, by deducting any balance owing under a Promissory Note, thirdly, from Annual Income, and lastly, from capital.
>
> -and-
>
> [A]s soon as practicable following transfer of the Annual Payment to the Revenue Account, the Trustee shall issue a Promissory Note to the Beneficiary for the amount of any Secondary Income that has not been distributed in that Fiscal Year. Where a balance remains owing under a Promissory Note from any previous Fiscal Year, the Trustee shall issue a Promissory Note to replace the earlier Promissory Note for the total outstanding amount owing, if any, as of that date. Each Promissory Note will be payable on demand and will bear no interest and shall be issued as *evidence of absolute payment by the Trustee of any Secondary Income* for a Fiscal Year of the Trust to the Beneficiary.[54]

52 Redacted source of Settlement Trust clauses filed with author.

53 *Exchange Act, supra* note 21, s 176(1).

54 Redacted source of Settlement Trust clauses filed with author [emphasis added].

Income received via a promissory note is recognized as income at the time that the note is issued, even if the payee has not received payment; that is, the *Tax Act* requires that a taxpayer claim certain kinds of income whether the income is already paid or *payable*, pursuant to section 12(1)(b).[55] Therefore, a Settlement Trust may avoid taxation on second generation income if a trustee were to issue a promissory note to the Band for the value of any secondary income.

As discussed earlier, in the trust creation process numerous consultants, including accountants, tax lawyers or advisors, trustees and drafting lawyers are retained to ensure that Settlement Trusts are drafted so that section 75(2) applies. It is often a lengthy process that incurs certain legal, tax and accounting costs. After the Settlement Trust has been settled and the assets are invested, further administrative tasks, a few of which include tracking the lines of investment income, tracking expenses and filing Trust returns, are required in order to manage the tax consequences.

Arguably, a Band should not be put in a position in which it has to adhere to these administrative processes and incur costs when this line of action is not required when dealing with any other type of Band income. The Band simply does not file a tax return for other sources of income that is considered tax exempt, pursuant to section 149(1)(c) of the *Tax Act*.[56] In the end, the effect of section 75(2) is the same in that trust revenues are attributed to the tax-exempt Band. It is difficult to reconcile, given the unique features of Settlement Trust structures, that Trusts are treated as "individual taxpayers" for tax calculation purposes. The very essence of a Band is communal in nature. It defies logic that trust assets that flow from a unique communal entity, a Band, in which income subsequently flows back to that same communal entity, would be taxed as a separate individual.

Bands are clearly not individuals and hold a unique position in Canadian society due to the nature of historical dealings between Indigenous peoples and the Crown. It makes sense to have Settlement Trusts distinguished from other personal trusts under the general trust provisions of the *Tax Act*. In the next section, I discuss the possibility of amending the *Tax Act* to exempt Settlement Trust revenues from being taxed under the general trust provisions so that Bands do not have to rely upon the application of section 75(2) to qualify for tax exemption on Settlement Trust revenues.

IV. AMENDING THE TAX ACT

Bands that create Settlement Trust structures are undoubtedly not individuals and should not be taxed under the general trust provisions of the *Tax Act*. If Settlement Trusts were exempted from being taxed under the general trust provisions, Bands could simply claim trust income just as any other income, directly through section 149(1)(c) of the *Tax Act*. Therefore, no tax return would need to be filed for these revenues, as is the case with all other Band revenues.

A *Tax Act* amendment that exempts Settlement Trusts from being taxed under the general trust provisions would eliminate the bureaucracy around the taxation of Settlement Trusts and simplify the administration for all parties involved, including for the Canada Revenue Agency. The Settlement Trust would not have to go through the administrative exercise of filing tax returns when the end result is that income will be attributed to the tax-exempt Band anyway. Further, the Canada Revenue Agency would not have to concern itself with the administration of numerous Settlement Trust returns that, through the application

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55 *Tax Act*, *supra* note 1, s 12(1)(b) [emphasis added]. For a more detailed discussion of how the *Tax Act* considers accrued income for tax purposes see Li et al, *supra* note 16 at 180.

56 See *MNP*, *supra* note 30.

of section 75(2), are tax exempt anyway. This could also result in greater clarity in the Settlement Trust creation process. To enact such an amendment several considerations would need to be contemplated.

The definition of what constitutes a Settlement Trust is critical. Obviously, they are created by Bands (in this case) and legally enacted through the deposit of settlement funds (and other Band assets). Additionally, to qualify for tax exemption under section 149(1)(c) of the *Tax Act*, a Band must be recognized under the Indian Act.[57] As such, it is likely that for a Settlement Trust to be exempted under section 104(2) of the *Tax Act*, it would need to be settled by an *Indian Act*-recognized Band. This is due to the Canada Revenue Agency's existing interpretation of Bands as public bodies performing functions of government in Canada.

At the heart of the justifications for exempting Settlement Trusts from the general trust provisions of the *Tax Act* is that *Indian Act* protections and *Tax Act* provisions both already address the tax treatment of revenues attributed to Indigenous peoples under certain conditions. I contend that amending the *Tax Act* to exempt Settlement Trusts from being included in the general trust provisions allows Bands to rely directly upon those provisions in the *Tax Act* that already treat Band revenues as tax exempt. For tax purposes, Settlement Trust revenues would then be treated just as any other Band revenues and taxed directly under section 149(1)(c) of the *Tax Act*. This is a more justifiable manner to treat these revenues because a *Tax Act* amendment would bring immediate and greater certainty to the issue of Settlement Trust taxation.

CONCLUSION

In Canada, it has been both socially and politically recognized by key stakeholders that, in many instances, Indigenous peoples' quality of life is substandard compared to the rest of Canadian citizens. In fact, it has also been legally acknowledged by the Supreme Court of Canada that Indigenous peoples lag in significant areas of economic development. Chief Justice McLachlin (as she then was) and Abella, J., writing for the majority in *R v Kapp*, conceded these differences when they indicated that "Aboriginal peoples experience high rates of unemployment and poverty, and face serious disadvantages in the areas of education, health and housing […] This disadvantage, rooted in history, continues to this day."[58]

The form of complicated taxation of Settlement Trust structures is yet another area where Bands are disadvantaged. Crucial Band resources that could be used for necessary public services are instead used to ensure administrative compliance with *Tax Act* provisions. Given that Bands rely upon trust structures as a source of sustenance for their communities, amending these provisions would be a significant step in addressing Band fiscal disadvantages.

Taxing Settlement Trust revenues under the general trust provisions puts the Trust in a position where it must rely upon section 75(2) to qualify for tax exemption. While it is unclear whether the Canada Revenue Agency could question the application of section 75(2) in this manner, the necessity for its application undoubtedly requires the engagement of certain administrative processes (arguably unnecessary) to manage tax and accounting considerations for tax compliance reasons.

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57 I reiterate here that Indigenous groups throughout Canada have varied circumstances, from the legal constitution of the group in question to the wide-ranging claims with Canada, the provinces or other third parties. My intention is to bring attention and solutions in regard to those groups who are already interpreted by the CRA as public bodies performing a function of government in Canada. To date this includes only *Indian Act*-recognized Bands.

58 *R v Kapp*, 2008 SCC 41 at para 59.

The current method of taxing Settlement Trust revenues under general trust provisions is in place because the Canada Revenue Agency has likely not given sufficient consideration to alternative solutions, the nature of the *sui generis* interests involved, and the implications of taxing Settlement Trust revenues in this manner. Unless challenged, the status quo prevails.

The problem of the administrative burden incurred could be resolved if the general trust provisions were amended to exclude Settlement Trust revenues from being taxed under these provisions. It is appropriate to remove the ambiguous processes and have settled law in this regard. It cannot be emphasized enough that these Trusts are important fiscal management vehicles for Bands and must therefore be carefully considered as unique and viable mechanisms to increase wealth in Indigenous communities.