

IRS Issues Advance Notice of Proposed Rulemaking on Definition of Essential Governmental Function for Indian Tribal Governments under Section 7871

The Department of the Treasury and IRS Counsel have issued an Advanced Notice of Proposed Rulemaking that applies to Indian Tribal governments and to State and local governments that issue bonds for the benefit of Indian tribal governments. This proposed rule addresses the definition of an "essential governmental function" under section 7871(c) of the Internal Revenue Code and the limitation of that term to activities customarily performed by State and local governments for purposes of section 7871(e) of the Internal Revenue Code. The IRS has become aware of an increasing number of instances in which taxpayers have raised questions about the application of section 7871(e). Accordingly, the Treasury Department and the IRS have determined to seek public comment in advance of issuing proposed regulations in this area. Public comments may be made regarding the proposed standard, as outlined at the end of this article.

Section 7871(a)(4) of the Internal Revenue Code of 1986 provides that an Indian tribal government is to be treated as a State "subject to subsection (c), for purposes of section 103 (relating to State and local bonds)". Section 7871(c)(1) provides that "section 103(a) shall apply to any obligation (not described in paragraph (2)) issued by an Indian tribal government (or subdivision thereof) only if such obligation is part of an issue substantially all of the proceeds of which are to be used in the exercise of any essential governmental function". Section 7871(e) provides that "for purposes of this section, the term 'essential governmental function' shall not include any function which is not customarily performed by State and local governments with general taxing powers".

The Treasury Department and the IRS anticipate that the proposed regulations will provide that for purposes of section 7871(c) and section 7871(e), an activity will be considered an essential governmental function that is customarily performed by State and local governments if: (1) There are numerous State and local governments with general taxing powers that have been conducting the activity and financing it with tax-exempt governmental bonds, (2) State and local governments with general taxing powers have been conducting the activity and financing it with tax-exempt governmental bonds for many years, and (3) the activity is not a commercial or industrial activity. The proposed regulations will further provide that examples of activities customarily performed by State and local governments include, but are not limited to, public works projects such as roads, schools, and government buildings.

Before the notice of proposed rulemaking is issued, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying.

Written or electronic comments must be submitted by **November 7, 2006**, to:

Internal Revenue Service
PO Box 7604
CC:PA:LPD:PR (REG-118788-06) Room 5203
Ben Franklin Station
Washington, DC 20044

Submissions may be sent electronically, via the IRS Internet site at <http://www.irs.gov/regs>, or via the Federal e-Rulemaking Portal at <http://www.regulations.gov> (indicate IRS and REG-118788-06).