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CURRENT TAX LAW DISPARITIES EFFECTING TRIBAL ECONOMIC DEVELOPMENT

The Tax Code has long provided a number of special provisions designed to help state and local governments secure economic advantages appropriate to their status as governments--such has tax-exempt bond financing, deductibility of charitable contributions received by them, and exemption from certain federal excise taxes. In addition, the Internal Revenue Code has been consistently interpreted not to impose an income tax on state, local and other governmental units. In 1982, Congress passed the Indian Tribal Governmental Tax Status Act in order to clarify how federally-recognized Indian Tribal Governments were treated for various federal tax purposes. Consistent with the principles of Indian self-determination, the Tax Status Act attempted to place Indian tribal governments on roughly the same footing as state and local governments. However, the playing field Congress created for tribes' issuance of tax-exempt bonds has never been completely level with that on which state and local governments operate. Tribes are subject to more restrictive rules. And those rules have never been adequately clarified to facilitate cost-effective compliance. All of these factors have resulted in a major chilling of the tax-exempt bond market with respect to Indian tribal government issuers and borrowers,

Current Tax Code Restrictions on Tribal Debt

There are three Tax Code provisions that apply only to tribal government bond offerings, and all three of these rules impose formidable restrictions on tribal debt: (1) the "essential governmental function" test; (2) the general prohibition on private activity bonds; and (3) the limited exception for tribal manufacturing facilities. In addition, some tribal governments have particular difficulty complying with certain generally applicable Tax Code restrictions, such as the prohibition on relying on federal funds to repay bonds.

Essential Governmental Function Test

Generally, interest on tribal debt that is issued by a tribal government will not be tax-exempt unless substantially all of the proceeds of the debt are used in the exercise of an "essential governmental function." IRC Section 7871(c)(1). Section 7871 of the Tax Code contains no definition of this amorphous term, but Section 7871(e) tells us that an activity will not be treated as an "essential governmental function" if it is not "customarily performed by state or local governments with general taxing powers."

A major problem with the essential governmental function test is that it defines what tribal governments may do with reference to what state and local governments "customarily" do, which is a moving target. For example, over the past several years, many municipalities have utilized bonds for various economic development activities-.g., hotels and other revenue-generating facilities. States have also increased the extent to which they conduct gaming activities (e.g., lotteries and racetracks).

On August 9, 2006, the Internal Revenue Service released an Advance Notice of Proposed Rulemaking (the “ANPR”) seeking public comment on regulations it intends to propose defining an “essential governmental function” for purposes of Section 7871(c) of the Code. The ANPR would limit the scope of an essential governmental function in ways not intended by Congress. Three requirements would have to be met in order for an activity to be an essential governmental function. Each of these requirements is problematic, ambiguous, and will compound the problems tribes face in financing their capital needs.

First, the activity must have been engaged in by “numerous” state and local governments. The ANPR does not indicate what “numerous” means. Recent IRS audit activity suggests that the IRS has a very restrictive definition of “numerous,” for instance, taking the position that governmentally owned convention center hotels have not been operated by “numerous” non-tribal governments even though several dozen have been created in the last few years.

Second, the activity must have been engaged in by non-tribal governments for “many years.” This requirement further harms tribes, as it is both ambiguous and would cripple tribes’ ability to respond quickly to innovative technologies. How many years after cities began to offer wireless internet services would tribes have to wait before being able to finance their own systems on a tax-exempt basis.

Third, the activity must not be a “commercial or industrial activity.” This requirement, like the other two, is both difficult to apply and crippling in its effect on tribes’ economic development. If a “commercial or industrial activity” is one that provides a fee for service, it would confine tribes to those activities that are not engaged in by private business, even if numerous non-tribal governments have engaged in them for many years. Non-tribal governments engage in numerous fee for service activities that are also engaged in for profit by private businesses, including, for example, electric service, gas service, waste disposal service, health care, higher education, parking, low income and special needs rental housing, sewer service, and recreational activities such as golf, swimming, tennis, and public marinas.

General Prohibition on Private Activity Bonds.

Indian tribal governments generally may not issue private activity bonds. IRC Section 7871(c)(2). Such bonds are frequently issued by state or local governments. For example, state and local governments often issue tax-exempt private activity bonds for the benefit of nonprofit organizations, or to finance mortgage loans for low-income home buyers or residential rental property. Private activity bonds are also issued for airports, docks and wharves, solid waste facilities, and certain energy or utility projects.

Limited Exception for Tribal Manufacturing Facilities.

There is only one narrow exception to the general prohibition on private activity bonds issued by Indian tribal governments. Under IRC Section 7871(c)(3), tribes may use tax-exempt bonds for a qualifying manufacturing facility. To so qualify, the manufacturing facility must be one used in the production of tangible personal property and meet three major tests--(1) it must be tribally owned and operated, (2) it must be located on lands which have been in trust for at least 5 years, and (3) it must meet periodic testing criteria for employing a certain number of tribal members or their spouses relative to the amount of bond proceeds utilized. Although this provision was well intended when it was passed, its requirements are exceedingly difficult to meet. They impose virtually untenable burdens on the type of capital-intensive, high technology plants that are built in the United States today.

In short, in extending tax-exempt bonding authority to tribes, Congress has enacted rules that are both burdensome for tribal governments to comply with and difficult for the IRS to administer. As noted by Professor Ellen Aprill, a former Treasury Department Attorney-Advisor, "in the Tribal Tax Act, tribal governments were given bonding authority they were unable to use and denied bonding authority they would have welcomed." See Aprill, "Tribal Bonds: Indian Sovereignty and the Tax Legislative Process," *46* Admin. Law Rev. 333, *348* (Summer 1994).

Recent IRS Administration of the Restrictive Tribal Bond Rules

In October of 2002. The Bond Buyer reported that the IRS was planning to implement a new compliance initiative aimed at tribal bond issuances and several other areas. Mark Scott, then the head of the IRS Bond Division, stated that the focus of the tribal audits would be to determine compliance with the "essential governmental function" test. See "IRS Eyeing Student Loans, TIFs, Tribal Debt for 2003," The Bond Buyer (Oct. 8, 2002). Following publication of the article, several bond practitioners and tribal attorneys criticized the IRS for proposing to enforce compliance with a test that it had never adequately explained or defined. The IRS subsequently downplayed any intent to target tribal bond offerings.

However, only a month later, the IRS released a National Office Field Service Advice (FSA) addressing the issue of whether the construction and operation of a golf

course by a tribe was an "essential governmental function." See FSA 20024712 (Aug. 12, 2002). The FSA concludes that although the construction and operation of golf courses are customary government functions, "there is an argument that the commercial nature of the [tribal] Golf Course causes it to be other than an essential governmental function within the meaning of [Internal Revenue Code] section 7871(e)." The version of the FSA released at that time was heavily redacted to suppress the opinion of the IRS Chief Counsel questioning whether the IRS field agent's proposed challenge to the tax status of the tribe's bonds would ultimately be successful if litigated in the courts.

Since 2003, the IRS has opened a relatively large number of audits of tribal bond transactions. Initially, the IRS audits targeted tribes that had engaged in conduit bond transactions--i.e., transactions in which a state or local government agency not subject to the restrictive rules issues bonds for the benefit of a tribal governmental borrower. Shortly thereafter, the IRS opened up at least a dozen audits involving transactions in which tribes issued governmental debt directly for their own use. IRS agents made it clear that a major focus of these audits is to challenge the use of bonds to finance infrastructure or facilities that supported a tribe's gaming operations. IRS agents have also made statements in the press questioning the propriety of using bonds to finance recreational facilities for tribes with small memberships.

1. In June of 2004, an IRS Advisory Committee recommended that the IRS take the following constructive steps to facilitate a better understanding of applicable rules by tribal governments and other parties in the bond market:

2. Request the Treasury Department to develop regulations defining "essential governmental function" under Section 7871;

3. Clarify that the term "essential governmental function" under Section 7871(e) should be construed in accordance with its construction under IRC Section 115;

4. Withdraw FSA 200247012 [the golf course Field Service Advice described above] and suspend issuance of other nonprecedential guidance;

5. Suspend any new compliance initiatives applicable to tribal bonds until after IRS regulations are issued.

See Advisory Committee on Tax Exempt and Government Entities (- ACT): Report of Recommendations (June 9, 2004) (IRS Publication 4344(5-2004)).

The Report, prepared by Navajo Nation attorney Raymond Etcitty, concluded with the following plea: "How can tribal governments develop sustainable economies that produce recurring revenue needed to provide the infrastructure for their citizens, residents and visitors, when tribal governments have their hands tied behind their back?" Mr. Etcitty noted that the Treasury Department had failed to publish any regulations interpreting the tribal bond provisions since such provisions were amended by Congress in 1987.

A second IRS Advisory Committee report, prepared approximately one year later, reported that the issues identified in the 2004 report "continue to fester, and the frustration continues to grow as the IRS has significantly expanded the number of Tribes under audit as issuers or borrowers of tax-exempt debt." The Committee concluded that "[these audit actions collectively have had a perhaps intended chilling effect on issuance of tax-exempt tribal debt, and at the same time have reinforced sentiments of bias among Indian tribal governments and their advocates." *See* Advisory Committee on Tax Exempt and Government Entities (ACT): Report of Recommendations (June 8**.** 2005), "Survey and Review of Existing Information and Guidance for Indian Tribal Governments.," pp. 12-13 (prepared by Lenor Scheffler and Robert Gips).

The release of the ANPR, described above, provides further evidence that only Congress has the power to deal with the problem.

Ill. RECOMMENDATIONS FOR LEGISLATIVE CHANGE AND OVERSIGHT

There are a number of things that Congress can do to improve the current situation in which tribes are effectively prevented from accessing capital at the same rates and on the same terms as other governments. Some of these involve legislative changes. Others involve oversight to foster more effective and even-handed tax administration.

Legislative Changes

There are two possible legislative changes that would help tribes access capital in a more cost-effective manner. First, Congress should pass legislation repealing or modifying the "essential governmental function" test under Section 7871 and should make some provision for private activity bonds - particularly with regard to affordable housing and energy projects financed by tribes. At the very least, Congress should gear the requirements of the tribal manufacturing facility exception to the real-life economic realities (including U.S. labor market costs) faced by 21st century manufacturing plants. Second, although not within the jurisdiction of this Committee, Congress should provide tribes that issue bonds the same treatment under federal securities laws that it has accorded to state and local governments.

Tax legislation

Repeal of the "essential government function" test is recommended because the last 20 years have demonstrated that the restriction is difficult to interpret and almost impossible to administer. These difficulties have resulted in an institutionalized bias against tribal governments as issuers of tax-exempt bonds and have erected insurmountable "barriers to entry" by tribes into the financial marketplace. Although the original purpose of the "essential governmental" function may have been to prevent tribes as bond issuers from being exploited by private parties, it has consistently been used

against tribes acting in a government capacity and seeking to finance economic development within the boundaries of their own reservations.

Second, Congress should open up the general private activity bond prohibition to allow tribes to selectively issue bonds that would otherwise be considered private activity bonds. Such a provision would allow tribes to issue tax-exempt bonds for various types of facilities that serve a legitimate governmental purpose-such as facilities used by 501(c)(3) organizations, affordable rental housing, electric generation plants, water treatment, solid waste and sewage disposal plants. At the very least, Congress should closely examine and revise the provision that allows tribes to issue tax-exempt bonds to finance their own manufacturing facilities. The requirements of this provision must be made consistent with the economic realities of modem-day manufacturing in the United States. Legislation introduced in past Congresses by Senator John McCain and others would have allowed tribes to issue tax exempt bonds permitted to be issued by State and local governments under current law, so long as the tribe maintained at least a 50% ownership stake in the financed facility and satisfied a more flexible employment test.

Senate Bill 1850 goes a long way toward dealing with many of the tax problems confronting tribal financing today. It eliminates the essential governmental function test for facilities located on an Indian reservation, and preserve it only for the financing of facilities located elsewhere, while excluding the portion of any building used for class II or class III gaming from eligibility for tax exempt financing. It would permit tribes to issue private activity bonds under the same circumstances as non-tribal governments so long as the financed facilities were on the reservation of the issuing tribal government. And it would abolish the special limitations on tribal manufacturing facilities.

Senate Bill 1850 could be improved to deal with a number of important technical problems, some of which are identified below.

First, SB 1850 would arguably not permit a tribe to be treated as a state or local government for purposes of bonds issued by a non-tribal government that in part benefit a tribe. For instance, a tribe’s rental of portions of a school complex financed by a county to provide supplemental education for tribal members would arguably be inconsistent with the non-tribal government’s use of tax-exempt financing.

Second, financing costs for tribes tend to be higher than those for non-tribal governments, and SB 1850 should make clear that amounts used to pay costs of financing are not net proceeds for purposes of the requirement that 95% of the net proceeds be spent on a facility located on the issuer’s reservation.

Third, SB 1850 requires that the facility financed by bonds not subject to the essential governmental function test be located on the issuing tribe’s reservation, and not just any Indian reservation. This limitation would make it difficult for multiple tribes to cooperate in the development of a joint use facility, and should be modified.

Fourth, the definition of an Indian reservation arguably would not include Alaska Native Villages.

Fifth, SB 1850 does not clarify the meaning of an “essential governmental function” for facilities located off-reservation, and should be modified to be more inclusive that would be permitted by the ANPR.

Sixth, Congress should also consider providing a special exception for certain tribal bonds from the "federal guarantee" prohibition. This prohibition generally comes into play where the governmental borrower relies on future federal assistance to repay the loan. It is largely irrelevant for gaming tribes with sufficient cash flow, but the provision creates problems for poor tribes and those with large memberships, particularly in the development of tribally owned-low income and special needs housing, where guarantees by HUD under the Section 6 and Section 184 programs can preclude the use of tax-exempt financing under current law. Tax-exempt bond issuances of such tribes may fail to secure approval of bond counsel or underwriter's counsel because of the level of federal assistance being received by the tribe.

Securities legislation

Congress should amend the Securities Act of 1933 to place bonds issued by tribal governments on par with those issued by state and local governments with respect to federal securities registration requirements. The current lack of exemption serves no useful purpose and simply imposes extra transactions costs on tribal governmental issuances.