NATIONAL CONGRESS OF AMERICAN INDIANS

CURRENT TAX NEEDS IN INDIAN COUNTRY

The National Congress of American Indians (NCAI), along with its partners, the Affiliated Tribes of Northwest Indians (ATNI), the California Association of Tribal Governments (CATG), the United South and Eastern Tribes (USET), and the Native American Finance Officers Association (NAFOA) – collectively, the Intertribal Tax Initiative, appreciate the opportunity to share our ideas on tribal tax policy.

As you know, Indian tribal governments have a unique status in our federal system under the U.S. Constitution and numerous federal laws, treaties and federal court decisions. American Indian and Alaska Native tribes have a governmental structure, and have the power and responsibility to enact civil and criminal laws regulating the conduct and affairs of their members and reservations. Tribes operate and fund courts of law, police forces, and fire departments. Tribes provide a broad range of governmental services to their citizens, including education, transportation, public utilities, health, economic assistance, and domestic and social programs. Like the revenue of states and local governments, tribal revenues are not treated as taxable income – but as the governmental revenues of a distinct and unique sovereign government.

As such, federal tax reform is of great interest to NCAI, its partners, and our respective member tribes. This is because tax reform presents a very real opportunity to protect and enhance the many governmental functions and services provided by Indian tribes. There are many ways to include tribal governments in any upcoming tax reform. While the federal government recognizes that tribal nations are governments, tribes are frequently treated less favorably than state and local governments under our federal Tax Code. Such differential and unjust treatment typically results in tribal governments being denied federal tax exemptions and economic development incentives that state and local governments enjoy.

In restructuring the nation's Tax Code, it is critical that members of Congress clearly understand both the unique problems and challenges of Indian Country and the governmental status of Indian tribes. Thus, in expressing our views on potential areas

to improve tribal tax policy, we do so as partners in American growth and, like each of you, as elected governmental representatives of Native American people.

Tribal Tax Parity--A History of Uneven Progress

While there is no federal statutory provision that "exempts" Indian tribes from federal income tax, the IRS has consistently and correctly concluded that federally recognized tribes and their federally chartered corporations are not subject to federal income taxes.[1] With respect to tribal governments, the IRS in Revenue Ruling 67-284 based its conclusion on the fact that tribes (like states) are political bodies not subject to the income tax provisions of the Internal Revenue Code (the "Code").

However, the IRS did not treat Indian tribes like states for all purposes of the Code. Revenue Ruling 68-231 provided that tribal bonds could not be treated like state government-issued bonds because Code section 103, which exempts interest paid on state and local bonds from income taxation, did not specifically mention Indian tribes. The IRS took a similar approach to several other Code provisions that explicitly exempted state and local governments.

Recognizing that tribal governments should be treated on par with state governments, Congress passed the **Indian Tribal Governmental Tax Status Act** in 1982 to provide comparable governmental tax treatment to tribes for federal tax purposes.[2] The Tribal Governmental Tax Status Act, codified as section 7871 of the Code, provides that federally recognized tribes are treated like states with respect to the following:

- Deductibility of charitable contributions to governments for exclusively public purposes
- Deductibility of gifts and bequests for public purposes
- Exclusion of interest on tax-exempt bonds (subject to restrictions on tribal bonds discussed below)
- Exemption from certain federal excise taxes (subject to restrictions)
- Deductibility of taxes paid to tribal governments
- Private foundation excise tax rules referencing governments
- Provisions relating to accident & health plans under Section 105

[1] Four revenue rulings address the tax status of tribal governments: Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 81-295, 1981-2 C.B. 15; Rev. Rul. 94-16, 1994-1 C.B. 19; and Rev. Rul. 94-65, 1994-2 C.B. 14.
[2] Title II of Pub. L. No. 100-203, 96 Stat. 2605 (1982).

- Provisions authorizing retirement plans under Section 403(b) for educational employees

Although Code Section 7871 did not codify the basic tax immunity of tribal governments, the legislative history indicates that Congress was aware of the IRS's position in Revenue Ruling 67-284 and did not wish to alter it.

Unfortunately, the Tribal Governmental Tax Status Act did not live up to its original promise of treating tribes on par with states for federal tax purposes. For example, the provision that allowed Indian tribes to issue tax-exempt bonds was subject to many restrictions in the original 1982 Act, and more were added in 1987. Thus, Indian tribal bonds were subject to the following restrictions:

- An absolute prohibition on the issuance of private activity bonds, except for certain tribal manufacturing bonds subject to wage and employment tests that are virtually impossible for modern manufacturing facilities to meet

- Government bonds issued by tribes were required to meet the essential governmental function test (which was considered to be met only when (the project does not generate revenue?)substantially all of the proceeds were used in the exercise of an essential governmental function)

- "Essential governmental functions" for this purpose were limited to those functions "customarily performed" by state and local governments with general taxing powers (e.g., schools, roads and sewers).

The Tribal Tax Status Act also applied the "essential governmental function" test to the excise taxes from which tribes were exempted, even though state and local government exemptions were not so restricted.

In addition to imposing specific restrictions on tribes that were not applicable to states, Section 7871 failed to address many areas of the Code where special treatment is extended to states. Unfortunately, the IRS took the position that these omissions demonstrated that tribes should not be treated like states, and denied governmental status with respect to a number of different provisions, including various federal excise taxes not covered by Section 7871. See, e.g., Revenue Ruling 94-81, 1994-2 C.B. 412 ("Indian tribal governments have no inherent exemption from federal excise taxes").

NCAI Priority--Tribal Tax Parity

NCAI, its partners, and our respective member tribes, firmly believe that because Indian tribes are governments, they should generally be treated like states for all federal tax purposes. As part of a comprehensive tax reform bill, Section 7871 needs to be

broadened to treat Indian tribes like states for all tax Code purposes, except in those limited instances where a special rule for tribal governments is absolutely necessary. In most cases, a special rule will not be necessary.

A special rule is needed so tribes can continue to offer 401(k) retirement savings plans. Since Congress amended the Code in 1995 to specifically clarify that tribes, unlike state and local governments, could offer 401(k) plans, many tribes have adopted 401(k) plans as the primary vehicle for their employees. Many would now like to supplement such plans with governmental pension plans, and corrective legislation is needed to accomplish that goal. But Congress should preserve the right of tribal employers to continue to sponsor 401(k) plans as well.

Specific Instances where the Tribal Tax Parity is Urgently Needed

While we believe that tribes should be treated like states for all tax purposes (and generally should not be subject to special rules or restrictions that states and local governments do not have to meet), there are several specific areas where tribal tax parity is urgently and particularly needed:

- Tax Exempt Bonds (including private activity bonds)
- Employee Benefit and Pension Plan
- Tribally Funded and Controlled Charities
- Treatment as States for purposes of federal streamlined sales tax legislation

Treating tribes like states in these four areas would be a significant step forward, and should be taken in the context of comprehensive tax reform.

Tribal issuance of tax exempt bonds

A provision championed by the Senate Finance Committee in the American Recovery and Reinvestment Act (ARRA) authorized $2 billion in bond authority for a new category of bonds for Indian tribes, known as "Tribal Economic Development ("TED") Bonds." TED Bonds were intended to provide tribes with more flexibility to use tax-exempt financing than is allowable under the current "essential governmental function" standards as noted above. The TED Bond rules are still subject to other restrictions that require financed projects to be located on Indian reservations and that prohibit the financing of gaming facilities.

The ARRA provision required Treasury to conduct a study of the effectiveness of the new bonding authority, and to recommend to Congress whether it should "eliminate or

otherwise modify" the essential governmental function standard for Indian tribal bond financing. That Treasury study is now complete and was delivered to Congress on December 19, 2011.

The core recommendation of the Treasury study is that Congress should adopt the same standard for tribal government bonds as applies to governmental bonds issued by State and local governments. The Treasury Department clearly recommends repealing the "essential governmental function" standard for Indian tribal governmental bond financing. The Treasury study explains that it is making this recommendation "[f]or reasons of tax parity, fairness, flexibility, and administrability . . . ."

Treasury also recommends that Congress adopt what it calls a "comparable" private activity bond standard so that Indian tribal governments could issue some private activity bonds. Such bonds would be subject to a national volume cap, and Treasury would be authorized to make allocations among Indian tribal governments.

Treasury has further recommended that Congress limit Indian tribal bond issuances in two respects: (1) No bonds could be used for gaming projects, and (2) some kind of project location restriction would apply. With respect to the latter, Treasury has recommended that Congress provide more flexibility than it did for the TED Bonds under ARRA. Specifically, Treasury recommends that tribal bonds be allowed to finance projects that are located on Indian reservations, together with projects that both: (1) are contiguous to, within reasonable proximity of, or have a substantial connection to an Indian reservation; and (2) provide goods or services to resident populations of Indian reservations.

NCAI, its partners, and our members appreciate the analysis and core recommendations in the Treasury study, but have serious concerns about the "project location restriction"--even in its modified form. In particular, the requirement that the financed project provide "goods or services" to reservation residents would effectively kill the chances of using tax-exempt debt for many tribal economic development projects. This directly infringes on tribes' ability to diversify their economic revenue generating base. The requirement for proximity to an Indian reservation would eliminate a tribe's ability to meet state-wide government contracting requirements. It is our view that tribal governmental bonds--as distinguished from private activity bonds--should <u>not</u> be subject to a "project location" restriction of any type. The Congress must remember that tribal governments do not have the typical taxing base of state and local governments and their business revenues are the core revenue base that enables tribes to become less dependent on federal resources.

Tribal pension and employee benefit plans

If the "essential governmental test" is unworkable in the government bond context, it is proving to be even more unworkable in the tribal employer plan arena.

Under a provision hastily conceived in a House-Senate Conference on the Pension Protection Act of 2006, tribal governmental plans are not treated as "governmental plans" unless all of the employees in the plan are substantially engaged in "essential governmental" functions, and not commercial activities. While the legislative history of the provision suggests that Congress intended to exclude casino, hotel, service station, casino and marina employees from being covered by a governmental plan (if the employer is a tribal government), it did not give much guidance how the test would apply in other contexts.

In many cases, because of their lack of a tax base to fund government operations, tribal governments tend to have employees engaged in what might be considered to be commercial activities. For example, employees in a tribal forestry department or roads and construction departments are similar to state and federal employees, but their activities sometimes result in generation of revenue. NCAI would also contend that if this test applied to contemporary state and local governmental workforces, they would find it to be equally unworkable.

The Senate-passed version of the 2006 pension legislation (S. 1783, 109th Cong.), which had strong bipartisan support from members of this Committee, contained a much more administrable and equitable approach to the treatment of tribal governmental plans. This language is reproduced below.

SEC. 1311. DEFINITION OF GOVERNMENTAL PLAN.

> (a) Amendment to Internal Revenue Code of 1986- Section 414(d) of the Internal Revenue Code of 1986 (definition of governmental plan) is amended by adding at the end the following: `The term `governmental plan' includes a plan established or maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency instrumentality (or subdivision) of an Indian tribal government, or an entity established under Federal, State, or tribal law which is wholly owned or controlled by any of the foregoing.'
> (b) Amendment to Employee Retirement Income Security Act of 1974- Section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)) is amended by adding at the end the following: `The term `governmental plan' includes a plan established or maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency instrumentality (or subdivision) of an Indian tribal government, or an entity established under Federal, State, or tribal law that is wholly owned or controlled by any of the foregoing.'

Tribal Charities

Under current federal tax law, the public charity status of section 501(c)(3) organizations funded by or formed to support Indian tribal governments is unclear. By contrast, the tax treatment of such charitable organizations funded by or formed to support federal, state and local governments is made clear by specific provisions of the Code (e.g., provisions treating such government funding as public support).

Consistent with the intent of the Tribal Government Tax Status Act to treat tribal government on par with other units of government, Congress should pass legislation to technically resolve this issue. The Senate has previously addressed it with a provision contained in Section 153 of the Senate-passed version of the Tax Administration Good Government Act (H.R. 1528, 108th Congress). That provision would have done the following: (1) treated tribal funding as public support for purposes of Section 170(b)(1)(A) (vi) (i.e., the public charity classification test that is satisfied on the basis of how much support a charity derives from "public" sources), and (2) treated charitable organizations formed to support Indian tribal governments the same as organizations formed to support state, local and federal government for purposes of Section 509(a)(3).

Unfortunately, the House and Senate did not go to Conference on that bill in 2006, although the provision was included in a bill passed by the House in 2007. This is a small technical fix that should be included in any comprehensive tax reform bill.

Tribal Tax Parity in the Context of Streamlined Sales Tax Legislation

When Indian tribal governments undertake economic development efforts, one reality that almost all tribes confront is the lack of a tax base. Tribes are not able to impose property tax on trust lands, and imposing an income tax on reservation residents or the businesses that choose to locate on reservations is rarely feasible. Recent federal court decisions have compounded the "tribal tax gap" by permitting the imposition of state taxation on Indian lands, while limiting the ability of tribal governments to tax non-Indians.

At the same time, Indian tribal governments do have the authority to impose and collect sales taxes on any product sold within their territorial jurisdiction. Although not all tribes exercise this inherent authority, tribes are increasingly relying on the imposition of taxes on transactions within their territory as a stable and long-term revenue source for tribal government operations.

For example, the Navajo Nation currently imposes a 4 percent general sales tax, which raises over $10 million dollars per year in revenue. In some situations, a tribal tax has to compete with applicable state taxes resulting in double taxation. However, in other cases, the state tax may be preempted, particularly if the incidence of the tax would fall directly on the tribe or a tribal member for a transaction occurring in Indian Country.

Several bills are pending in the Senate that would clarify which state has the right to impose its tax on on-line or Internet sales transactions. However, neither S. 1452 (the Main Street Fairness Act) nor S. 1832 (the Marketplace Fairness Act) takes into account the taxing jurisdiction of Indian tribes with respect to sales that are sourced within Indian Country, particularly where the purchaser is the tribe or a tribal member.

NCAI and its partners would like to collaborate with Congress to craft appropriate amendments to the legislation in order to accomplish the following:

- Facilitate participation by federally recognized Indian tribal governments in the Streamlined Sale and Use Tax Agreement as "member states" if they meet certain conditions;

- Make clear that the federal legislation is not intended to override longstanding principles of federal law governing the respective taxing jurisdictions of state and tribal governments, particularly with respect to purchases made by tribes and tribal members within Indian reservations and trust lands; and

- Protect existing bilateral agreements between states and tribes for the collection and allocation of sales tax revenues.

Statutory language contained in prior streamlined sales tax bills, such as S. 34 (introduced by Senator Enzi in the 110th Congress), could be used as a starting point to achieve these goals.

Tribal Tax Parity and IRS Audits

The Finance Committee has heard testimony in previous committee hearings--in 2006 and 2008--regarding the disproportionate number of IRS audits focused on tribal bond offerings. The large number of tribal bond audits conducted by the IRS between 2002 and 2007, together with the restrictive approach taken by the IRS in these audits, had the effect of chilling the market for tribal bonds at a time when credit was otherwise available for government projects.

More recently, IRS audits have focused on the social welfare programs of tribal governments. Starting in approximately 2004, the IRS began a special audit focus on tribal government programs providing in-kind benefits to tribal members. As a result of that initiative, the IRS began focusing on tribal government programs, including the following:

- Health Care Programs
- Educational Programs

- Housing Programs (including preparation of reservation home sites for building, housing improvement, construction, down payment assistance, and maintenance/repairs)
- Loan Programs
- Emergency Assistance
- Cultural Events and Community Activities (e.g., powwows)
- Cultural Travel
- Elder and Youth Programs (including meals, social events and utility assistance)
- Legal Aid
- Recreation and sporting events
- Landscaping and grounds maintenance

The underlying premise of these IRS examinations appears to be that Indian tribal governments are paying out taxable income (whether in cash or in kind) to or on behalf of tribal members. The IRS is auditing the tribal governments based on the premise that they (as payors) have obligations to report such payments to the IRS (and the payees) by issuing 1099s, and, in certain cases, to also withhold tax on such payments.

In a June 28, 2007 correspondence to Senator Charles Grassley, Steven Miller, the then IRS Commissioner for Tax Exempt and Governmental Entities, made the following statements under the heading "Tribal Per Capita Payments":

> *Under the Indian Gaming Regulatory Act, revenues from tribal gaming can be used for several authorized purposes, including funding tribal government operations, providing for the general welfare of the tribe, and making per capita payments to tribal members. Per capita distributions are subject to Federal income tax, and the issuer must report the distribution on Form 1099.*
>
> *To reduce the tax consequences to tribal members,* ***some tribes have created mechanisms to classify what should be taxable per capita payments as general welfare program payments, excludible from income, often through liberal interpretations of what constitutes a "needs-based" program.*** *Others have created or invested in purported income deferral programs….*
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> *To address this problem we have engaged in educational and enforcement activities. We also initiated* ***139 examinations during the past two years that focused specifically on the use of net gaming revenues.***

Further, the IRS Indian Tribal Governments (ITG) Work Plan for FY 2009 (posted on the IRS website at www.irs.gov/tribes) made the following statement about its Gaming Revenue enforcement initiative:

> *The Gaming Initiative commenced by the Office of Indian Tribal Governments in FY2005 will continue into FY2009. Continuing discussions with the Chairman of the National Indian Gaming Commission indicate their extreme interest in ensuring that tribes appropriately use gaming revenues, and properly account for such use. Since they have limited oversight of that issue,* ***it falls upon the IRS to ensure that information reporting requirements are met with regard to the expenditure of such revenues****. With Indian gaming now surpassing $26 billion in gross revenue for 2007, and expected to grow by over $2 billion per year, our role and responsibilities will continue to expand. We plan to devote 6 FTEs to this initiative, and our examination goal includes 40 returns from this initiative."*

In testimony at a September 18, 2009 hearing before the Senate Committee on Indian Affairs on the IRS treatment of tribal government health programs, Sarah Hall Ingram, the current IRS Commissioner for Tax Exempt and Governmental Entities, denied that the agency was targeting Indian tribal governments or that it had any special program to examine tribal health programs. Rather, Commissioner Ingram contended that "the issue of the taxability of medical benefits and health insurance coverage can arise from time to time in the normal course of an audit as we look at whether a tribe, or any other type of government or employer, is following appropriate information reporting and withholding practices as it administers its various programs."

More recently, on November 15, 2011, the IRS announced that it would be reexamining the applicability of the general welfare exclusion as applied to tribal government programs. Indian tribes have been asked to submit written comments to the IRS describing their programs, particularly the following.

- **Cultural** (for example, programs involving tours of sites that are historically significant to a tribe; language preservation programs; community recreational programs; cultural and social events);
- **Education** (for example, programs providing tutors or supplies to primary and secondary school students; job retraining programs for adults);
- **Elder programs** (for example, programs providing heating assistance or meals); and
- **Housing** (for example, programs providing housing on and off the reservation, with income limits different from those of the United States Department of Housing and Urban Development).

See IRS Notice 2011-94 at http://www.irs.gov/pub/irs-drop/n-11-94.pdf. As a result of this recent administrative focus, many tribal leaders are concerned that IRS audits of tribal programs are likely to increase, along with potential tax withholding and reporting burdens imposed on tribal governments.

Notwithstanding IRS statements to the contrary, NCAI believes that the IRS actions in auditing tribal governments on their social welfare and other governmental programs are clearly not comparable to IRS treatment of state and local governments. There is no

evidence that any similar audit initiative exists for state and local government programs. Based on this recent history, and in accordance to a recently passed resolution at our Midyear Conference (NCAI Resolution #LNK-12-008[3]), NCAI invites Congress to consider a legislative approach to addressing the IRS' treatment of tribal general welfare programs.

Need to Evaluate the Effectiveness of Tax Incentives for Tribal Governments

NCAI and its partners understand that Congress is engaged in a review of numerous expired or expiring tax provisions and is in the process of reviewing their effectiveness. During this process, we would like to offer our assistance in further evaluating the following incentives for Indian Country development.

- Accelerated Depreciation for Indian Reservation Property
- Indian Employment Tax Credit
- Indian Coal Credit
- Clean Renewable Energy Bonds (CREBs)
- New Markets Tax Credit

Based on initial feedback from NCAI member tribes, as well as our partners' members, we believe that providing Accelerated Depreciation for Indian Reservation Property has the potential to be a significant and meaningful incentive but only if it is enacted on a longer-term basis and appropriately targeted to encourage investment that would not otherwise occur. The Indian Employment Credit is too complex and has not been widely utilized by the Tribes. We would like to explore why the Clean Renewable Energy Bonds have not been allocated to any tribal government users. However, it is our understanding that the New Markets Tax Credit and Indian Coal Credits are considered to be effective incentives for economic and resource development.

New Proposals

We would also like Congress to consider incentives that tribally-owned enterprises could actually use, including the following:

- Payroll Tax Credit for On-Reservation Employment
- Energy Tax Incentives that Tribes could Utilize More Effectively than CREBs.

[3] *available at*: http://www.ncai.org/initiatives/partnerships-initiatives/ncai-tax-initiative/LNK-12-008_-_General_Welfare_Exclusion_Resolution.pdf.

NCAI and its partners look forward to working with Congress on these and other issues in the context of comprehensive tax reform.

For further information regarding any of the topics discussed herein, please contact John Dossett, General Counsel or Derrick Beetso, Staff Attorney at (202) 466-7767.