



Federal Tax Reform: Potential Impact on Tribes and their Members-- Fundamental Issues and Hot Topics

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INTRODUCTION AND OVERVIEW

- Taxation of Tribes and Tribal Business Entities
- Taxation of Native American Individuals
- Tribal Employer Tax Issues
- Tribal Government Bond Financing Issues
- Federal Legislation Streamlining State Taxation



TAXATION OF TRIBES & TRIBAL BUSINESS ENTITIES

- Present Law – Indian Tribe is not a taxable entity.
Rev. Rul. 67-284; Rev. Rul. 94-16
- Rationale – Tribes not included in IRC section 1 (individuals, trusts and estates) or IRC section 11 (corporations)
- Scope – no reservation-boundary limitation on tribal tax immunity



TAXATION OF TRIBES (cont'd.)

- In addition, tribal governments are treated like states for purposes of certain other tax benefits, including:
 - a) Income, estate and gift tax deductibility for contributions;
 - b) Certain private foundation rules applicable to tribes
 - a) Tax-exempt bond financing authority (limited)
 - b) Exemption from various excise taxes (generally limited)
- See Indian Tribal Governmental Tax Status Act of 1982, 26 U.S.C. §7871.



UNINCORPORATED DIVISIONS OR INSTRUMENTALITIES OF GOVERNMENT

- Tribe may also operate a business through an unincorporated division or instrumentality.
- Income earned by a Tribe from an unincorporated division operated on or off the reservation is not subject to tax. See Rev. Rul. 94-16.
- An instrumentality must be an “integral part” to earn income free of federal tax.



TRIBAL GOVERNMENT-CONTROLLED BUSINESS CORPORATIONS

- Federal Law
- Tribal Law
- State Law



FEDERAL LAW CORPORATIONS

- Federally recognized tribes are eligible to form corporations chartered under federal law.
 - Section 17 of the Indian Reorganization Act (“IRA”).
 - Section 3 of the Oklahoma Indian Welfare Act (“OIWA”).
- Advantages of Federal Law Corporations
 - Relative certainty of tax treatment. See Rev. Rul. 94-16 and 94-65 and check-the box regulations..
 - Retention of sovereign immunity (except as specifically waived).



FEDERAL LAW CORPORATIONS (cont'd)

- Disadvantages

- Lengthy charter approval process.
- Difficult to amend
- Can only be revoked by an Act of Congress



STATE LAW CORPORATIONS

- A Corporation organized under state law is fully taxable, even if the entity is wholly-owned by (and would otherwise qualify as an “integral” part of) the Tribe.
 - See Rev. Rul. 94-16
 - Private Letter Ruling (PLR) 9826005 (March 20, 1998)
- Generally, not a good option for a tribal joint venture.



TRIBAL LAW CORPORATIONS

- Since 1994, the tax status of tribal law corporations has been uncertain.
- 1996, preamble to check-the-box regulations said IRS was “studying the issue”.
- Starting in 2001, Treasury and IRS committed to clarify the tax treatment.
- Now, the IRS guidance project expanded to include entities owned by state, local or tribal governments.



INTEGRAL PART DOCTRINE

- Whether an enterprise qualifies as an integral part of the Tribal Government depends on all facts and circumstances.
- Two key factors are:
 - 1) The Tribe's degree of governance control over the enterprise; and
 - 2) The Tribe's financial commitment to the enterprise.



LEGISLATION NEEDED?

- No legislation needed so long as the pending IRS rulemaking reaches right result
- All government-owned and controlled business entities should be treated as integral parts of the government if they meet the two prongs of the “integral part” test—governance control and financial commitment
- Monitor carefully to make sure that IRS/Treasury does not make integral part status dependent on type of activity in which the business entity engages (e.g., commercial vs. essential governmental)



TAXATION OF NATIVE AMERICAN INDIVIDUALS

- General Rule: Individual Indians generally are subject to federal income tax (as well as other federal taxes), unless a statute or treaty provides an exemption. *Choteau v. Burnet*, 283 U.S. 691 (1931); *Squire v. Capoeman*, 351 U.S. 1 (1956).



STATUTORY EXCLUSIONS APPLICABLE TO NATIVE AMERICANS

- IRC Section 7873 exempts income from the exercise of treaty fishing rights.
- 25 U.S. Code §§ 1401-1408 exempts from tax per capita distributions from certain Indian land claims judgments or settlement funds.
- IRC Section 139D excludes from income all payments or reimbursements for medical expenses by an Indian tribe to a tribal member, spouse or dependent.



EXCLUSION FOR INCOME DIRECTLY DERIVED FROM RESTRICTED LAND

- In *Squire v. Capoeman* (1956)—excluded income from sale of timber on lands allotted under the General Allotment Act
- Rev. Rul. 56-342—exempted income “derived directly,” including rentals and royalties, proceeds from sales of natural resources, crops and grazing income.
- Rev. Rul. 67-284—exemption extended to income directly derived from allotments established by other congressional acts (if exemption provision similar to the General Allotment Act).



GAMING DISTRIBUTIONS

- Distributions from gaming revenues are taxable and subject to withholding under IRC Section 3042(r).
- In audits of tribal governments, IRS has been treating certain in-kind benefits as deemed distributions of gaming revenues.



MINORS TRUSTS

- Distributions of gaming revenues into a minors trust may or may not be currently taxable.
- In 2003, the IRS released Revenue Procedure 2003-14, which provided various safe harbor requirements for minors trusts.
- Trusts meeting the requirements are treated as tribally-owned grantor trusts, and the per capita payments or trust earnings are not included in the beneficiaries' incomes until actually or constructively received.



MINORS TRUSTs (cont'd)

- In 2011 the IRS published Revenue Procedure 2011-58, which included the following changes or clarifications to Rev. Proc. 2003-12:
 - Clarifies that an IGRA trust must be an ordinary trust
 - Clarifies that trustees may make staggered distributions to beneficiaries at different ages or upon the occurrence of specific events
 - Eliminates the references to federal and local trust law, as the **validity of trusts is governed by state or tribal law**
 - Broadens the class of survivors who may inherit a beneficiary's trust interest
 - Modifies the trustee discretions provisions for making health and welfare distributions.



GENERAL WELFARE TAX EXEMPTION

- IRC Section 61(a): Except as otherwise provided by law, gross income means all income from whatever source derived.
- General Welfare Exclusion: payments under governmental social benefit programs for the promotion of the general welfare are not includible in a recipient's gross income. Rev. Rul. 2009-19, 2009-28 I.R.B. 111; Rev. Rul. 98-19, 1998-1 C.B. 840; Rev. Rul. 74-205, 1974-1 C.B. 20.



GENERAL WELFARE (cont'd)

- To qualify under the exclusion, the payments must:
 - (1) be made to an individual under a governmental program,
 - (2) be for the promotion of the general welfare (that is, based on need), and
 - (3) not represent compensation for services. Rev. Rul. 2003-12, 2003-1 C.B. 283; Rev. Rul. 2005-46, 2005-2 C.B. 120.



TRIBAL PROGRAMS UNDER IRS SCRUTINY

- Education: pre-school, post-secondary, tutoring, clothes, room/board, etc.
- Cultural Events and Community Activities
- Housing Assistance (utility payments, loans, grants, etc)
- Loans
- Emergency Assistance
- Burial
- Cultural Travel and Education



TRIBAL PROGRAMS UNDER IRS SCRUTINY (cont'd)

- Legal Aid
- Recreation
- Elder Services
- Life Insurance – premiums or self-insured policy



LEGISLATION NEEDED?

- Possible need for statutory exclusion for educational and cultural programs—depending on outcome of IRS consultation
- Need to clarify that per capita withholding does not apply to in-kind benefits or tribal program expenditures
- Fix the “Kiddie” Tax so that it does not apply to distributions from minors trusts (those amount—even if taxable—should be taxed at the child’s rate and not the parent’s rate of tax)



TRIBAL EMPLOYER TAX ISSUES

- Payroll Issues
- Employee Plan Issues



PAYROLL TAX ISSUES

- Tribal governments and enterprises generally subject to payroll taxes
- Notable Exceptions
 - Tribal Council Member stipends excluded from wages;
 - FUTA exemption for employees “in the employ” of an Indian tribe. See Blue Lake Rancheria (9th Cir.2011)



EMPLOYEE PLAN ISSUES

- Prior to passage of PPA 2006, it was unclear when a tribal employer was eligible to maintain a “governmental plan” (or follow private employer rules under ERISA and IRC).
- Section 906 of PPA 2006 included certain Indian tribal plans in the definition of “governmental plans” but only if all of the plan participants were employees “substantially all of whose services . . . are in the performance of essential governmental functions, but not in the performance of commercial activities.”



LEGISLATION NEEDED?

- Legislation needed to fix Section 906 of the Pension Protection Act that imposes an inequitable standard on tribal government plans, which is based on the distinction between an employee's activities (essential governments vs. commercial)
- Standard is almost impossible to comply with so many tribes are electing to simply have one plan, and conform to the private employer plan rules
- IRS cannot fix this on its own. See Client Alert in handouts.



TRIBAL GOVERNMENT FINANCING ISSUES

- Currently IRC §7871(c) (applicable only to Indian tribal governments) limits use of tax-exempt bonds to financing of “essential governmental functions.”
- Moreover, activities cannot qualify as essential government functions unless they are “customarily performed” by state and local governments with general taxing powers. IRC §7871(e) .



TRIBAL GOVERNMENT FINANCE

- In 2006, Treasury and IRS promulgated an ANPR regarding the essential government function test.
- ANPR stated that an activity would not be treated as an “essential governmental function” unless (i) numerous state and local governments were conducting the activity and financing it with tax-exempt bonds (ii) such government had been doing so for many years and (iii) the activity was not a commercial activity.



ARRA TRIBAL ECONOMIC DEVELOPMENT BONDS

- The American Recovery and Reinvestment Act added IRC §7871(f) to provide Indian tribal governments more flexibility to finance economic development tax-exempt bonds.
- ARRA provided Treasury with authority to allocate up to \$2 billion of Tribal Economic Development Bonds among Indian tribal governments.
- Because of the tight credit markets from 2009 through 2010, only about five percent of the allocations were utilized.



TREASURY REPORT ON TRIBAL BONDS

- Treasury Department mandated to study TEDBs and report to Congress on whether “permanent fix” is needed.
- Treasury Report recommends that Congress repeal the essential governmental function restriction for governmental function restriction for tribal governmental bonds.
- Treasury also recommends that Indian tribes be permitted to issue a limited volume of private activity bonds.



LEGISLATION NEEDED?

- Legislation is needed to repeal the essential governmental function restriction on tribal bonds
- Legislation is also needed to allow tribes (and tribal entities, such as 501(c)(3) organizations created by tribes) to issue private activity bonds
- See Treasury Proposal in Handouts.



Federal Streamlining of State Sales Tax

- How should Internet sales to tribal members residing on a tribe's reservation be taxed?
 - (a) only by the tribe, if at all
 - (b) by the state and the tribe (double taxation)
 - (c) only by the state in which the reservation is located.



Federal Streamlined Sales Tax (cont.)

- Numerous bills have been introduced in the House and the Senate that would facilitate a more streamlined or uniform system of state taxation of Internet sales transactions. See H.R. 3179, H.R. 2702, H.R. 1860 and S. 1832, S. 1452, S. 971.
- If one or more of the bills mentioned above is passed without corrective amendments, it is very likely that federal common law doctrines preempting state taxation of Indian tribes and tribal members will be overridden.



Legislation Needed?

- Pending legislation must be amended to ensure that the common law doctrines preempting state tax on Indian Country sales transactions (both the categorical preemption and the Bracker balancing test) are not legislatively over-ridden.
- Legislation should also be amended to affirmatively provide for the participation of tribes as member states (if they so elect) in the Streamlined Sales and Use Tax Agreement --or other mechanisms by which tribes may impose their tax (in lieu of state tax) on Internet sales to delivery addresses within their jurisdictions



QUESTIONS AND ANSWERS?

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