



**To the Committee on Finance of the U.S. Senate
In connection with its May 15, 2012 hearing on
TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES**

**Statement submitted for the Record by Chairman W. Ron Allen
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The Jamestown S'Klallam Tribe appreciates this opportunity to submit testimony for the record in connection with the Senate Finance Committee's recent hearing on "Tax Reform: What It Could Mean for Tribes and Territories."

Indian tribal governments have a unique legal status under the U.S. Constitution and numerous federal statutes, court decisions and treaties. Indian tribes are political bodies with a governmental structure. They have the power and responsibility to enact various laws regulating the conduct and affairs of their citizens and trust/reservations lands. Tribes provide a broad range of governmental services to their citizens, including education, transportation, public utilities, health, economic assistance, natural resource management, elder care and social/cultural programs.

The Jamestown S'Klallam Tribe (the "Tribe") is a federally-recognized Indian tribe whose lands are located on the Olympic peninsula in Washington State. "S'Klallam" means "the Strong People." In keeping with its heritage and traditions/culture, the Tribe seeks to be self-sufficient and to provide high-quality governmental programs and services that address the unique social, cultural, natural resource and economic needs of its people. Like many other Indian tribes throughout the United States and unlike most state and local governments, the Tribe does not have a tax base.

Tribes across the United States cannot depend on the federal government to live up to its Treaty obligations and historical promises, so they must develop Tribal businesses to generate revenues to provide the essential services to their citizens. Thus, when an Indian tribal government borrows money to fund infrastructure or major projects, it must demonstrate to lenders that its tribal enterprises will furnish a steady source of revenue to ensure repayment.

Federal tax reform is of great interest to our Tribe and its citizens. There are many ways in which the federal tax system is in need of reform. While Tribal Nations are generally treated as governments and, as such, their undistributed income is not subject to federal tax, they are frequently treated less favorably than state and local governments under our federal Tax Code and by the Internal Revenue Service. Such

federal differential treatment results in Indian tribal governments being denied certain federal tax exemptions and incentives that state and local governments typically enjoy -- such as access to tax-exempt financing. In addition, disproportionate IRS audits have resulted in an actual chilling of the bond market for Indian tribal issuances and in the imposition of a federal toll charge on tribal governmental expenditures for the health, education and welfare of their citizens.

Federal tax reform represents a significant opportunity to provide more consistency in the federal Tax Code with respect to governmental entities--including state, local and tribal governments.

I. The Senate's Consistent Recognition of the Importance of Tribal Tax Parity

The Senate Finance Committee has established a consistent track record of working on a bipartisan basis to recognize that Indian tribes should be treated on par with states for federal tax purposes. The Indian Tribal Governmental Tax Status Act was based on legislation introduced in 1981 by Senators Wallop, Bradley, Hatfield, Packwood and Baucus (S. 1298, 97th Cong.). The legislation's goal was to put Indian tribes on par with states for federal tax purposes. While the Indian Tribal Governmental Tribal Tax Status Act (codified in Section 7871 of the Tax Code) fell short of its original intent in several respects, it represented a significant step toward the goal of governmental tax parity.

Since the early 1980s, the Senate has consistently recognized the need to put Indian tribes on par with states--particularly, in the areas of federal unemployment tax, tribal tax-exempt bonds, tribal pension plans, and tribal charities.

- In 2000, many Senators, including several current members of the Finance Committee, supported the inclusion in a House-Senate conference of a provision to treat tribes like states for Federal Unemployment Tax Act (FUTA) purposes. See S. 3152 (Community Renewal and New Markets Act of 2000), introduced by Sen. Roth on October 3, 2000 and co-sponsored by 34 members of the Senate, including Senators Baucus, Conrad, Grassley, Hatch, Kerry, Rockefeller and Schumer). This important legislation was enacted in 2001.

- In 2003 and 2007, several Senators, including Senators Baucus, Campbell, Gordon Smith, Inouye and others introduced or co-sponsored legislation to treat tribes like states for tax exempt bond purposes. See S. 1546 (Tribal Tax-Exempt Fairness Act) (introduced on July 31, 2003) and S. 3567 (Tribal Tax-Exempt Bond Parity Act) (introduced July 24, 2007).

- In 2006, the Senate passed S. 1783, including a provision championed by Senator Gordon Smith to treat pension and employee benefit plans sponsored by tribes the same as state and local governmental plans. Unfortunately, in the House-Senate conference on the Pension Protection Act of 2006, the Senate's provision was significantly modified to apply a different standard for tribal plans.

- Also in 2006, the Senate-passed version of the Tax Administration Good Government Act (H.R. 1528, 108th Cong.) included a provision to treat tribes the same as states with respect to the public charity status of 501(c)(3) organizations formed, funded and/or controlled by tribes. Unfortunately, this bill did not go to conference with the House.

Notwithstanding this long and consistent history, there are many ways in which tribes are not treated as states for federal tax purposes.

II. Tribal Tax Parity -- Priority Legislative Issues

A. Tribal Tax-Exempt Financing

The Finance Committee's consideration of tribal tax-exempt financing in the context of tax reform is timely. There has been a need to change the tax law applicable to such bonds for many years, but the current economic climate highlights in even greater relief the harsh realities of the financial market and the steep challenges faced by tribes in financing the many worthwhile projects in Indian Country. Now that the Treasury Department's study has acknowledged that current law is lacking in "tax parity, fairness, flexibility and administrability," it is time for Congress to move forward and adopt new rules for tribal bonds. See Department of Treasury, Report and Recommendations to Congress regarding Tribal Economic Development Bond Provision under Section 7871 of the Internal Revenue Code (December 19, 2011). Senator Baucus, in his remarks at the hearing on May 15, 2012, recognized the need for change in this area when he stated that "Congress should...level the playing field for tax-exempt bonds."

There are several key components to legislation that would effectively level the playing field for tribal tax exempt bonds, including:

- Eliminating the essential governmental function test for tribal governmental bonds
- Avoiding the imposition of other unworkable restrictions, such as a territorial limitation on tribal bond financed facilities
- Repealing the prohibition on private activity bonds and substituting a workable volume limitation procedure
- Providing tribal governments the same exemption from registration and disclosure rules currently provided to states in Section 3(a)(2) of the Securities Act.

We firmly believe that the lack of a tribal tax base may justify other measures to remove the barriers to federal guarantees of certain types of tax-exempt debt issued by Indian tribal governments. These political measures will significantly enhance Indian tribes' ability to generate alternative revenue sources to provide for critically needed services to their communities and citizens.

1. Eliminating the Essential Governmental Function Test

Under current law (other than through the special provision for tribal economic development bonds contained in the American Recovery and Reinvestment Act), Indian tribal governments are allowed to issue tax-exempt bonds only to finance facilities that serve an "essential governmental function." While neither the statute nor any IRS regulation defines what constitutes an "essential governmental function," the legislative history describes the test in terms of activities "customarily performed by State and local governments with general taxing powers." It is frequently very difficult to determine—with the certainty that a tax-exempt debt offering requires—whether particular activities are "customarily performed" by states and municipalities. While it is clear that Indian tribes may finance roads, schools and sewers, the essential governmental function test has become troublesome when applied to many other areas in which state and local governments have become increasingly active – *e.g.*, convention centers, tourist accommodations and public recreational facilities including golf courses, energy production and distribution facilities, parking and transportation—just to name a few. Moreover, because the standard is both fact-specific and open to IRS interpretation, the chances of inequitable and uneven treatment increase dramatically.

By contrast, the standard generally applicable to state and local government bonds (the "state/local government standard") has proven to be a workable one. It is met if either 90 percent or more of bond proceeds are used for governmental use (the "private business use" test), or 90 percent or more of debt service is payable or secured from governmental payments or property (the "private payment" test). While there will undoubtedly be interpretive issues with respect to what constitutes a governmental use, and what constitutes a governmental payment, we believe that these issues will be much easier to work out and apply to the Indian tribal government context than the essential governmental function test. Thus, the state/local government bond standard should be extended to include Indian tribal government bond financings.

In sum, replacing the essential governmental function test with the state/local government standard has at least three advantages: (1) the state/local government standard is more administrable than the essential governmental function test, (2) as a policy matter, Indian tribal governments should not be treated differently than state and local governments, and (3) the private business use test (or, alternatively the private payment test) should be sufficient for ensuring that tax-exempt bond proceeds are used appropriately.

2. Avoiding the Imposition of Other Unworkable Restrictions

While the Treasury Department has agreed that the essential governmental function test is unworkable and should be repealed, it continues to recommend that Congress consider enacting some kind of territorial or locational restriction on tribal tax-exempt financing. Like the pilot provision in ARRA limiting the use of Tribal Economic Development Bonds (TEDBs) to projects located on Indian reservations, a tax proposal in the Obama Administration budget for FY 2013 would require that tribal bond-financed projects be located on or near Indian reservations. See Treasury Department, General

Explanation of the Administration's Revenue Proposals (released February 2012), p. 51 (http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx). Under the Administration's tribal bond proposal, projects located "near" as opposed to "on" a reservation would be required to "provide goods or services to resident populations of Indian reservations." It should be noted that no similar locational restriction applies to state or local government bonds, while private activity bonds merely need to demonstrate a "nexus" or "substantial connection" to the jurisdiction of the bond issuer.

The territorial limitation in ARRA would, if extended to a broader range of tribal bonds, cause numerous practical problems. Many Indian tribes do not have much land, particularly land which has been accepted into trust by the United States. Other tribes may have ample reservation or trust land, but their locations are frequently so remote that no revenue-generating facilities can be placed there. The land also may not be in a location where significant community services, such as health care or education, can be rendered to the tribe's citizens. The proposed territorial limitation places these tribes at a serious disadvantage.

In light of these facts, we strongly recommend that any future legislation contain no territorial restriction whatsoever as long as the proceeds are not for private use (*i.e.*, no territorial restriction on tribal government bonds). We also think that a flexible standard should apply to tribally-issued private activity bonds. If Congress believes a territorial restriction is necessary, it should allow tribes to finance projects that have a "substantial connection" or an appropriate "nexus" to a Tribe's reservation, using a definition for the term "reservation" that is no more restrictive than the one found in Code Section 168(j) (Accelerated Depreciation).

The "substantial connection" or "nexus" test is illustrated in Private Letter Ruling 8442023 (July 12, 1984). In this ruling, the IRS permitted an industrial development authority to finance a hotel approximately 10 miles outside its jurisdictional boundaries because the issuer was able to show that there would be a direct, material benefit to the issuing jurisdiction. This approach would provide Indian tribes with the flexibility to finance nearby projects that directly benefit the Tribe as a whole. Further, the "substantial connection" or "nexus" test applies to state and local governments, and Indian tribal governments should be accorded the same treatment.

Another potentially unworkable restriction concerns the use of bonds for gaming facilities. While we would urge Congress not to impose such a restriction (particularly with respect to Indian tribal gaming facilities that are both owned and operated by the tribe), we also understand that permitting tax-exempt financing of gaming facilities is a political issue. If Congress is unwilling to lift this restriction in its broader revision of the rules governing tribal bond issuances, we request the adopt a more flexible approach to the use of tax-exempt financing for hotel, convention and other facilities that are ancillary to a gaming facility.

The approach taken by the IRS in the TEDB guidance is too restrictive. In IRS Notice 2009-51, the IRS required Indian tribal governments seeking an allocation of bond issuing authority to certify that

no portion of the proceeds of any Tribal Economic Development Bonds issued pursuant to the requested application will be used to finance any portion of a building in which class II or class III gaming, as defined in section 4 of the Indian Gaming Regulatory Act, is conducted or housed, or any other property actually used in the conduct of such gaming.

To be certain of compliance, a tribal applicant must avail itself of an IRS safe harbor, which is described IRS Notice 2009-51 as follows:

As a safe harbor, a structure will be treated as a separate building if it has an independent foundation, independent outer walls and an independent roof. Connections (e.g., doorways, covered walkways or other enclosed common area connections) between two adjacent independent walls of separate buildings may be disregarded as long as such connections do not affect the structural independence of either wall.

This safe harbor has given rise to significant confusion in practice. In formulating workable standards, Congress should clarify that tax-exempt financing is allowed for projects, such as convention centers and hotels, built adjacent to and even integrated in with tribal casinos. This lack of clarity has had a chilling effect on Tribal development projects and is likely to result in the adoption of architectural designs which are aesthetically and functionally inferior.

3. Repealing the Prohibition on Private Activity Bonds

The revenue proposal contained in the FY 2013 Administration Budget would allow Indian tribal governments to issue tax-exempt private activity bonds for the same types of projects and activities as are allowed for State and local governments under Section 141(e) under a national bond volume cap. In addition, the same volume cap exceptions applicable to State and local governments would apply to the tribal tax-exempt bonds. However, unlike state and local private activity bonds, tribal private activity bonds (like all tribal bonds) would be subject to a territorial or project location restriction and a gambling facility restriction.

As noted above, the Treasury proposal would employ a national bond volume cap for Indian tribal governments, which it describes as comparable to that applicable to states, but also "tailored" to the tribal context:

This tailored national Tribal private activity bond volume cap for all Indian tribal governments together as a group would be in an amount equal to the greater of:

- (i) a total national Indian tribal population-based measure determined under Section 146(d)(1)(A) (applied by using such national Indian tribal population in

lieu of State population) [*\$190,000,000 based on an assumed Indian tribal population of 2,000,000 nationwide*], or

(ii) the minimum small population-based State amount under Section 146(d)(1)(B) [*\$284,560,000 in 2012*].¹

The Treasury proposal would delegate to the Treasury Department the responsibility to allocate this national bond volume cap among Indian tribal governments.

Allocation schemes have not worked well for Indian Country bond financings. For example, Congress provided an allocation scheme for state, local and tribal governments to issue Clean Renewable Energy Bonds (CREBs), but no tribal governments received CREBs allocations. Congress also provided an allocation scheme for TEDBs, and while the national volume cap of \$2 billion was fully allocated among over 75 tribes in two tranches, we understand that only 5% of this amount had been issued by the expiration date, and now the remaining 95% is going to have to be re-allocated. Many tribes applied for allocations with little or no readiness to issue debt, while others were not able to use their allocation because it was too small and did not cover the cost of the project to be financed.

If tribal private activity bonds are subject to a locational restriction and a gambling facility restriction, they should not also be subject to a national volume cap that must be allocated among the over 500 tribal government issuers.

B. 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 negotiated by 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 on how the test would apply in other contexts.

¹ According to the US Census website (<http://quickfacts.census.gov/qfd/states/00000.html>), there are an estimated 2,804,327 self-identifying American Indian/Alaska Native individuals in the US as of 2011. This number reflects people who self-identify as AI/AN, not the number of enrolled members. By contrast, in the BIA’s 2005 American Indian Population and Labor Force Report, the latest available, the total number of enrolled members of the (then) 561 federally recognized tribes was shown to be 1,978,099. See <http://www.bia.gov/cs/groups/public/documents/text/idc-001719.pdf>. Given the 7 years that have passed since that BIA report was issued (including changes in the number of federally recognized tribes), it is unclear whether this number remains accurate.

Consequently, tribal government employers have been hamstrung in their efforts to maintain governmental plans, and economically coerced to adopt private employer plans. Because of the typical mix of tribal governmental and economic development functions, the 2006 provision is uniquely ill-suited to the needs of tribal government employers. We also suspect that if the test applied to present-day state government workforces, they would find it 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. Such language is reproduced below as follows.

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.

Congress should adopt similar language to eliminate the dysfunctional complexity of present law and to put tribal governmental plans on par with state and local plans.

III. Specific Instances Where IRS Audits Have Targeted Tribal Governments

A. Tribal Bond Audits

The Finance Committee has already heard testimony in previous committee hearings--in 2006 and 2008--regarding the disproportionate number of IRS audits focused on tribal governmental 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, has had the undeniable effect of chilling the market for tribal bonds at a time when credit was otherwise available for government projects.

B. Recent IRS Audits Focused on General Welfare Programs of Tribal Governments

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 Programs (including meals, social events and utility assistance)
- Legal Aid
- Recreation and sporting events
- Landscaping and grounds maintenance

The underlying assumption behind these IRS examinations is that Indian tribal governments are distributing taxable income (whether in cash or in kind) to or on behalf of tribal members. Furthermore, the IRS is auditing the tribal governments based on the legal premise that they (as payors) have obligations to report such payments to the IRS (and the payees) by issuing 1099s. In certain cases, the IRS has also contended that the in-kind benefits represent deemed per capita payments of gaming revenues, and thus the tribal government must withhold tax on such payments under Section 3402(r).

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 may increase, along with potential tax withholding and reporting liabilities imposed on tribal governments. Tribal leaders and their representatives also take issue with the IRS' attempt to characterize these programs as involving deemed per capita distributions, citing the inconsistency between the IRS' overly definition of a per capita payment and the Department of Interior's approach in regulations and other guidance promulgated under the Indian Gaming Regulatory Act. See 25 C.F.R. § 290.2 (distinguishing between per capita and social welfare payments).

Recent IRS actions in auditing tribal governments on their social welfare and other governmental programs are clearly not comparable to IRS' current or historical treatment of state and local governments. There is no evidence that any similar audit initiative exists for state and local government programs. The tribal governmental audits should be suspended--at least until such time as the IRS has articulated the relevant legal standards that apply to tribal government programs. The Jamestown S'Klallam Tribe is especially concerned about the IRS focus on educational and cultural programs.

Conclusion

Tax reform affords Congress an opportunity to re-fashion the Tax Code so it is simpler and fairer. Tribal governments have long been subjected to tax laws that are neither simple nor fair. By consistently treating tribes like states (and eliminating the special rules that are so unworkable), Congress can go a long way toward tax reform with respect to tribal governments. In addition, Congress needs to exercise oversight over the IRS to ensure that its administration of the Tax Code (including through IRS examinations) is equitable and appropriate. Such reforms--whether achieved through statutory changes or legislative oversight-- will empower Tribal governments to progressively advance their self-governance and self-reliance goals to relieve the historical dependency of Indian communities on federal resources.