Tribal Bonds Under Scrutiny

BY KATHLEEN M. NILLES

WITH INTEREST RATES AT RECORD LOW LEVELS, MANY tribal governments are exploring the use of tax-exempt bonds to finance a variety of tribal projects. The advantages of tax-exempt financing are several. First, the interest rates tends to be significantly lower than commercial bank lending — due in part to the tax exemption accorded to municipal bond interest. Second, municipal debt offerings tend to have longer time horizons — 25 to 30 years in many cases — which results in significantly smaller annual payments. Bottom line: Tax-exempt bonds can save tribes money and preserve cashflow when a major project must be financed with borrowed funds.

A New Compliance Initiative?

On October 8, 2002, The Bond Buyer, a leading trade journal for bond professionals, reported that the IRS was planning a new compliance initiative aimed at tribal bond issuances. The fact that Indian tribal bonds showed up as one of 22 areas on the IRS Bond Division's audit "work plan" is not particularly surprising. For years, the IRS has been examining a number of qualified bond issuers and borrowers — from state and local governments to universities and hospitals. The IRS bond rules are carefully crafted to restrain abusive and inappropriate practices. From the IRS's perspective, compliance with this fairly complex set of rules is the price of admission to a valuable tax benefit.

What is surprising, however, is the IRS's approach in these upcoming compliance audits. The head of the IRS's bond division, Mark Scott, told The Bond Buyer that the focus of the tribal audits would be to determine compliance with the "essential governmental function" test. "A key issue," he then asserted, "will be to define the central [i.e., essential] governmental function." Following publication of this report, several tribal tax and bond attorneys expressed concern that the IRS would be attempting simultaneously to enforce and to make the applicable rules.

The tax-exempt bond rules applicable to federally recognized tribes date back to the mid-1980s. In 1982, Congress passed the Indian Tribal Governmental Tax Status Act (now enshrined in Section 7871 of the Internal Revenue Code) to provide tribes with the same federal tax treatment as state and local governments. The Act states that tribes are to be treated like states for purposes of the bond rules, but makes them subject to a couple of specific restrictions. First, tribal governments are permitted to issue bonds only to finance facilities that serve an "essential governmental function." Second, tribes are not permitted to issue private activity bonds except for certain manufacturing facilities operated by the tribal government. While neither the statute nor any IRS regulation defines what constitutes an "essential governmental function," the Act's legislative history describes the test in terms of activities "customarily performed by State and local governments with general taxing powers."

At first glance, it seems that Congress intended for tribes to operate on a level playing field with other governmental bond issuers. However, it is frequently difficult to determine whether particular activities are "customarily performed" by states and municipalities. The standard is an evolving one, and based on a myriad of facts-and-circumstances. While it is clear that tribes may finance roads, schools and sewers, the standard becomes troublesome when applied to certain other areas in which state and local governments have become increasingly active in recent years — e.g., convention centers, tourist accommodations and recreational facilities.

Options for Tribal Planners

In an October 17 follow-up article in The Bond Buyer, Scott suggested that tribes consider requesting an IRS private letter ruling to resolve whether a specific bond transaction meets the essential governmental function test. The Bond Buyer mentions that the letter ruling process "typically takes four to six months." Unfortunately, such an expedited timeframe has not been my experience. IRS letter rulings do provide the ultimate insurance policy for requesting taxpayers and tax-exempt entities. However, if you decide to go that route, you need to leave yourself plenty of time to secure IRS approval.

Another option is to retain experienced bond counsel at the front end of your planning process. Bond counsel can provide the tribe with an opinion that a particular bond transaction meets IRS requirements. However, a bond opinion does not prevent the IRS from challenging the tax treatment your lawyer thinks you should receive. And the threat of IRS audits is likely to make bond attorneys more cautious.

In some areas of the country, notably California and Florida, tribes are exploring the possibility of so-called "conduit financing." Such financings require that a tribe pair up with a state or local government agency that has authority to issue bonds to other governmental and nonprofit entities. The primary advantage of these cooperative ventures is that meeting the essential governmental function test is not required when a state or local government issues debt on behalf of a tribe, only when the tribe itself issues the bonds. Unfortunately, such state-tribal cooperation will be politically unfeasible in many regions.

A Legislative Solution?

The lack of a genuinely level playing field for tribal bond offering has prompted many legislators to propose tribal tax-exempt bond reform. The National Congress of American Indians has called for tax-exempt bond reforms on several occasions, and the National Indian Gaming Association (NIGA) has taken a leadership role on this issue in the 107th Congress. NIGA expects to continue pressing for change when the newly elected Congress convenes next year. Tribal leaders can lend critical support to this effort by asking their elected representatives to create a playing field that is truly level for tribal government bonds. □

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