

Expanding Financing Opportunities in Indian Country: IRS Issues Guidance which Clarifies the "Essential Governmental Functions" Test for Issuing Tribal Bonds

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Over the past several years, tribal bonds issued on a tax-exempt basis have received considerable scrutiny from the IRS. The scrutiny culminated in the now-famous decision by the IRS to deny tax-status to \$22.5 million in bonds issued by the California based Agua Caliente Band of Cahuilla Indians to finance an upscale golf course. The IRS attacked the tax-exempt status of tribal bonds on the basis that the bonds were not issued "essential governmental function", which in turn has led to a great deal of uncertainty with respect to the types of activities that will meet the essential governmental functions test.

Following the heels of the recent congressional creation of "tribal economic development bonds" -- which are not subject to the essential governmental functions test -- the latest installment of IRS guidance offers a glimmer of hope that the tide may turn to re-open tax-exempt finance in Indian Country. On March 13, 2009, the IRS publicly released Private Letter Ruling 200911001, which provides significant guidance for the issuance of tax-exempt bonds by Indian Tribes. The significance of PLR 200911001 lies with the analysis the IRS employed to assess whether an activity of an Indian Tribe meets the "essential governmental functions" test under the federal tax law. The essential governmental functions test has long been a point of contention with Indian Tribes.

Background on the Requirements to Issue Tribal Bonds

The issuance of tax-exempt bonds is a significant tool employed by state and local governments to finance the costs of public projects. Section 103 of the Internal Revenue Code of 1986, as amended ("*IRC*") grants an exemption from income tax for interest paid on bonds issued by state and local governments. Indian Tribes are not included within the definition of "State or local government"; however, by virtue of another section of the IRC, an Indian Tribe or its political subdivisions may be treated as a state or political subdivision of a state for purposes of IRC § 103.

The IRC imposes an additional criterion for an Indian Tribe to be treated as a state or local government. Specifically, substantially all of the bond proceeds must be used by the Tribe "in the exercise of any *essential governmental function*." Not atypical with federal tax laws, the IRC does not provide a bright-line standard classifying activities which are an essential governmental function. Instead, the IRC simply provides a negative definition which provides that an essential governmental function does "not include any function which is not *customarily* performed by State or local governments with general taxing powers." Hence, there has been considerable uncertainty with respect to what activities meet the essential governmental functions test.

Background on the Proposed Bond Issue in PLR 200911001

The actual purpose of the proposed bond issue in PLR 200911001, standing alone, is not very noteworthy. The project is an electric generating facility. The issuer would be a county electrical district (the "*Issuer*"). The electrical district is a creature of state law and, thus, is a political subdivision of the state.

The undisclosed Tribe in PLR 200911001 is federally recognized. The actual borrower (the "*Borrower*") of the bond proceeds is a political subdivision of the Indian Tribe and is so-recognized pursuant to Rev. Proc. 2002-64. The Borrower's purpose is to provide utility services to the tribal population. Under controlling Tribal law, the utility services must be provided on a nonprofit basis and at reasonable cost to all areas of the Tribe's reservation. The board of the Borrower was appointed by the Tribe's governing council.

Under the financing arrangement discussed in PLR 200911001, the Borrower would enter into a contract with the Issuer to purchase an undivided interest in a power plant. Pursuant to the contract, the Borrower would be liable for the repayment of a pro rata share of the principal and interest of the bonds.

The Three-Part Essential Governmental Functions Test of PLR 200911001

After engaging in a lengthy analysis of the legislative history of IRC § 7871, the IRS concluded that an activity is considered to be an essential governmental function that is customarily performed by a state or local government when three elements are satisfied. The three elements announced by the IRS are:

- (1) there are numerous state and local governments with general taxing powers that have been conducting the activity and financing it with tax-exempt governmental bonds;
- (2) state and local governments with general taxing powers have been conducting the activity and financing it with tax-exempt governmental bonds for many years; and
- (3) the activity is not a commercial or industrial activity.

The IRS further stated in employing its three-part analysis with respect to the ownership and operation of a facility, "only comparable facilities owned and operated by states and local governments may be taken into account."

Useful Guidance, Perhaps? The IRS's Analysis Under Its Three-Part Test

The application of the IRS's three-part test potentially offers useful guidance to assess whether a tribal activity is one which is "customarily" performed by a state or local government. At the outset, the IRS quickly dispensed with the first two prongs of the analysis. The IRS acknowledged that municipalities have long owned, operated and financed municipal power utilities. Additionally, the IRS noted that municipal-owned power utilities are often financed on a tax-exempt basis.

The application of the third element of the test is particularly interesting. The IRS framed the issue under the third prong as "whether ownership and operation of" an interest in a power plant "is a commercial or industrial activity." Acknowledging that the legislative history provides no criteria to determine what constitutes a commercial or industrial activity, the IRS resorted to examining the well-established body of law under IRC § 501(c)(3). A number of court decisions have analyzed whether the activities of 501(c)(3) organizations serve a commercial purpose. The relevant factors the IRS examined, therefore, were whether the Borrower would operate the power plant (1) to earn a profit, (2) in competition with for-profit entities, and (3) in a commercial manner.

Ultimately, the IRS was able to distinguish the Borrower's ownership of the power plant in PLR 200911001 from an investor-owned utility. For instance, Tribal law required the Borrower to operate on a nonprofit basis. Accordingly, the project lacked a commercial hue and, thus, met the essential governmental functions test.

Concluding Comments

PLR 200911001 is a significant development in that it provides insight with respect to the IRS's analysis of the Tribal activities which may be customarily performed by state or local governments. By examining exempt activities under IRC § 501(c)(3), PLR 200911001 appears to depart from the stringent approach utilized in the audit of the tax-exempt bonds issued by the Agua Caliente Band of Cahuilla Indians and the now famous FSA 20024712 (Nov. 11, 2002). The implications could re-open tax-exempt financing markets to Tribal governments to finance a variety of projects, potentially including recreational facilities which are ancillary to casinos. Thus, although the actual project financed could be mundane, the application of the three-part analysis is significant news.

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