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**ENCOURAGING ECONOMIC SELF-DETERMINATION
IN INDIAN COUNTRY**

before the

**SUBCOMMITTEE ON LONG-TERM GROWTH AND DEBT REDUCTION
SENATE COMMITTEE ON FINANCE**

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INTRODUCTION

Good morning, Chairman Smith, Senator Baucus, and distinguished members of the Senate Finance Committee and this subcommittee. My name is Wayne A. Shammel. I am the General Counsel of the Cow Creek Band of Umpqua Tribe of Indians. On behalf of the Cow Creek Tribe, I would like to thank you for the opportunity to discuss the challenges that Indian tribal governments face in encouraging economic self-determination in Indian Country, particularly as they relate to federal tax policy and tax administration—two key areas that fall within the legislative and oversight jurisdiction of this committee.

I would like to personally thank Senator Baucus and Senator Smith for your leadership on federal tax issues affecting Indian tribes over the past several years. Senator Smith, you have distinguished yourself by introducing and shepherding through the Senate a comprehensive set of provisions (sections 1311 through 1313 of S. 1783) to clarify the status of tribal government-sponsored pension plans. Senator Baucus, you have lent strong support for these provisions and taken a leadership role on many other provisions to treat tribal governments like other governments for federal tax purposes. Both of you have also advocated for the passage of tax incentives to spur private investment in Indian country, such as Indian reservation accelerated depreciation and the Indian employment tax credit – both of which expired on December 31, 2005 and urgently need to be extended.

The Cow Creek Tribe is one of nine federally recognized Indian tribes in the State of Oregon. It has approximately 1,300 members and is governed by an elected eleven-member Board of Directors. The Tribe has a rich history in southwestern Oregon that reflects hard work, perseverance and the desire to be self-reliant.

Over 150 years ago, the Cow Creek Tribe was one of the first two tribes in Oregon to secure a treaty with the United States. This treaty was ratified by the U.S. Senate on April 12, 1854. However, the treaty was not honored and the Tribe's governmental status was officially terminated in 1954. Relegated to marginal lands and forced to live a subsistence lifestyle, the members of the Cow Creek Tribe endured for 130 years until they again secured federal recognition of the Tribe's status and received modest compensation for lands taken away from them.

The Cow Creek Tribe regained federal recognition in 1982 when President Reagan signed P.L. 97-391. Then, in 1984, a court awarded the Tribe a settlement in the amount of \$1.3 million. The Tribe invested the funds in an endowment to purchase what is known as "evergreen" land. The Tribe was also able to use the investment earnings on the endowment for economic development, education, housing, and assistance to elders.

In 1992, the Tribe opened a Bingo Hall which has become the Seven Feathers Hotel & Casino Resort, a full service Indian resort and gaming facility. Through the Umpqua Indian Development Corporation, the Tribe has diversified its business endeavors. In addition to operating the Seven Feathers in Canyonville, the Tribe owns and operates several other businesses, including Creative Images Media Group, Seven Feathers Truck & Travel Center, Umpqua Indian Foods, Canyon Cubbyholes, Riverside Motel, Valley View Motel, Rivers West RV Park, Rio Communications, K-Bar Ranches, and Umpqua Indian Utility Cooperative.

The Tribe's economic diversification benefits tribal members, local residents, and the surrounding communities. In 2004, Cow Creek contributed \$107.1 million to the local economy in 2004 and sustained 1,610 payroll jobs. The Tribe also provides telecommunications services and other utilities. See ECONorthwest, The Economic Benefits of the Cow Creek Tribe to Douglas County, Oregon (A Net Economic Benefit Analysis) (Nov. 18, 2005) (copies provided to Subcommittee staff and available at <http://www.cowcreek.com/ca/CountyBenefits.pdf>).

The Tribe is currently working on a large project that will provide sewer treatment and water services not only to its Tribal enterprises located in Canyonville, but also to the entire City of Canyonville. The Tribe will hold a grand opening for the new Creekside RV Park and has recently partnered with the Oregon Department of Transportation to develop a rest stop at Exit 99 on I-5, which will benefit all travelers through this corridor.

The Tribe's Board of Directors supports and sponsors a wide range of projects – schools, local festivals, camps, sports teams, community events, and philanthropic organizations. The Tribe places a high priority on education for tribal as well as other community members. In 1997, the Tribe established the Cow Creek Umpqua Indian Foundation, which awards grants on a semi-annual basis and donates funds each year to Coos, Deschutes, Douglas, Jackson, Josephine, Klamath and Lane Counties, all in southern Oregon.

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Cow Creek's testimony contains three major segments. First, it provides a brief description of the challenges faced by tribal governments in accessing capital for economic development projects. Second, it focuses on how these challenges are exacerbated by certain provisions in tax code, and how such provisions are administered by the IRS. Third, it suggests how members of the Finance Committee and this Subcommittee could help ameliorate the situation through their support of remedial legislation and their exercise of oversight jurisdiction.

I. ECONOMIC DEVELOPMENT

Indian Country today is often seen as a world of economic extremes. While a few high-profile tribes have prospered economically in recent years, there are hundreds of tribes that are still struggling. Unemployment, poor health care, and substandard housing are typical of the more “invisible” reservations and the families and other individuals who inhabit them. In Eastern Oregon, for example, the Burns Paiute Tribe is located hours from any major population center and is plagued by an unemployment rate of approximately 82 percent. The community is located on a small amount of land and has few natural resources.

Nationwide, the real per-capita income of Indians living on reservations is still less than half of the national average. Unemployment on reservations is still double the average rate in the rest of the country. There is no question that further strides toward greater economic self-determination must be made.

When Indian tribal governments undertake economic development efforts, one reality that 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 locate on reservations is rarely feasible. Recent Supreme 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.

Faced with these limitations, tribes often pursue a variety of economic development ventures as a substitute for reservation tax revenues. Over the past 15 years, gaming revenues have proven to be the most consistently successful substitute for tax revenues to sustain the general revenue fund of the tribal government. (During this same period, many state governments have significantly expanded their lottery operations as an alternative to raising taxes.) However, many tribes are either unable or unwilling to put all of their eggs in the gaming basket.

In pursuing economic development projects, state and local governments frequently utilize tax-exempt financing. The advantages of tax-exempt financing are several. First, the interest rates tend 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—20 to 30 years in many cases—which results in significantly smaller annual or monthly payments. The bottom line is that tax-exempt bonds can save governments money and preserve cash flow—especially when a major project must be financed with borrowed funds.

At present, tribal governments are not able to access financing on the same terms as state and local governments. Tax-exempt bond financing, in particular, is not available for many projects that tribes undertake—even those that are identical to projects undertaken by states and municipalities. Stadiums, hotels, affordable rental housing, utility and energy projects—these are just a few of the projects that tribes generally cannot finance with tax-exempt bonds because of Tax Code restrictions and IRS interpretations. In addition, tribes are subject to certain SEC registration rules from which state and local governments are completely exempted, and this lack of exemption materially adds to the interest and issuance costs that tribal governments must bear in a tax-exempt financing. The current-law tax-exempt bond restrictions are explored in further detail below.

II. CURRENT TAX LAW AND IMPACT ON TRIBAL ECONOMIC DEVELOPMENT

The Tax Code has long provided a number of special provisions designed to help state and local governments secure economic advantages appropriate to their status as governments—such as tax-exempt bond financing, deductibility of charitable contributions received by them, and exemption from certain federal excise taxes. In addition, the Internal Revenue Code has been consistently interpreted not to impose an income tax on state, local and other governmental units.

In 1982, Congress passed the Indian Tribal Governments Tax Status Act in order to clarify how federally-recognized Indian Tribal Governments were treated for various federal tax purposes. Consistent with the principles of Indian self-determination, the Tax Status Act attempted to place Indian tribal governments on roughly the same footing as state and local governments.

However, the playing field Congress created for tribes' issuance of tax-exempt bonds has never been completely level with that on which state and local governments operate. Tribes are subject to more restrictive rules. And those rules have never been adequately clarified to facilitate cost-effective compliance. Moreover, under a recent IRS audit initiative targeting tribal bond offerings, tribal governments that issue bonds have a 40 percent chance of having the tax status of their bonds challenged in a IRS audit, compared to an average audit rate of approximately 1 percent for state and local bonds.

All of these factors have resulted in a major chilling of the tax-exempt bond market with respect to Indian tribal government issuers and borrowers.

Current Tax Code Restrictions on Tribal Debt

There are three Tax Code provisions that apply only to tribal government bond offerings, and all three of these rules impose formidable restrictions on tribal debt: (1) the “essential governmental function” test; (2) the general prohibition on private activity bonds; and (3) the limited exception for tribal manufacturing facilities. In addition, some tribal governments

have particular difficulty complying with certain generally applicable Tax Code restrictions, such as the prohibition on relying on federal funds to repay bonds.

Essential Governmental Function Test. Under this restriction, interest on debt that is issued by a tribal government will not be tax-exempt unless substantially all of the borrowed proceeds are used in the exercise of an “essential governmental function.” IRC § 7871(c)(1). Section 7871 of the Tax Code contains no definition of this amorphous term, but § 7871(e) tells us that a function will not be treated as an “essential governmental” one if it is not “customarily performed by state or local governments with general taxing powers.” The term “substantially all” is not defined either—but it is generally thought to mean at least 95 percent of the debt proceeds.

Based on their knowledge of the functions commonly performed by state or local governments, experienced bond counsel have advised tribes that such essential governmental functions should include tribal administration buildings, schools, hospitals and medical clinics, fire and police facilities, community and convention centers, parks and recreational facilities, public marinas, public parking and tribal purchases of land for public purposes. Based on examples in the legislative history explaining this restriction, it is fairly clear that tribes can also use bonds for basic infrastructure, such as the development of road and streets, sewers, and certain utilities (e.g., water distribution and wastewater treatment plants). However, it is difficult to opine with certainty under this test.

A major problem with the essential governmental function test is that it defines what tribal governments may do with reference to what state and local governments “customarily” do—which is a moving target. For example, over the past several years, many municipalities have utilized bonds for various economic development activities—e.g., hotels and other revenue-generating facilities. States have also increased the extent to which they conduct gaming activities (e.g., lotteries and racetracks). The IRS has never issued any guidance on the level of state or local government activity necessary to qualify it as a “customary” activity. Moreover, because of their lack of a tax base, tribes are more likely to be interested in utilizing bonds for activities that generate revenues, and not just to finance infrastructure and the provision of government services.

General Prohibition on Private Activity Bonds. Indian tribal governments generally may not issue private activity bonds. IRC § 7871(c)(2). Such bonds are frequently issued by state or local governments. For example, state and local governments often issue tax-exempt private activity bonds for the benefit of nonprofit organizations, or to finance mortgage loans for low-income home buyers or residential rental property. Private activity bonds are also issued for airports, docks and wharves, solid waste facilities, and certain energy or utility projects.

Limited Exception for Tribal Manufacturing Facilities. There is only one narrow exception to the general prohibition on private activity bonds issued by Indian tribal governments. Under IRC § 7871(c)(3), tribes may use tax-exempt bonds for a qualifying manufacturing facility. To so qualify, the manufacturing facility must be one used in the production of tangible personal property and meet three major tests--(1) it must be tribally owned and operated, (2) it must be located on lands which have been in trust for at least 5 years, and (3) it must meet periodic testing criteria for employing a certain number of tribal members or their spouses relative to the amount of bond proceeds utilized. Although this

provision was well intended when it was passed, its requirements are exceedingly difficult to meet. They impose virtually untenable burdens on the type of capital-intensive, high-technology plants that are built in the United States today.

In short, in extending tax-exempt bonding authority to tribes, Congress has enacted rules that are both burdensome for tribal governments to comply with and difficult for the IRS to administer. As noted by Professor Ellen Aprill, a former Treasury Department Attorney-Advisor, "in the Tribal Tax Act, tribal governments were given bonding authority they were unable to use and denied bonding authority they would have welcomed." See Aprill, "*Tribal Bonds: Indian Sovereignty and the Tax Legislative Process*," 46 Admin. Law Rev. 333, 348 (Summer 1994).

Recent IRS Administration of the Restrictive Tribal Bond Rules

In October of 2002, *The Bond Buyer* reported that the IRS was planning to implement a new compliance initiative aimed at tribal bond issuances and several other areas. Mark Scott, then the head of the IRS Bond Division, stated that the focus of the tribal audits would be to determine compliance with the "essential governmental function" test. See "IRS Eyeing Student Loans, TIFs, Tribal Debt for 2003," *The Bond Buyer* (Oct. 8, 2002). Following publication of the article, several bond practitioners and tribal attorneys criticized the IRS for proposing to enforce compliance with a test that it had never adequately explained or defined. The IRS subsequently downplayed any intent to target tribal bond offerings.

However, only a month later, the IRS released a National Office Field Service Advice (FSA) addressing the issue of whether the construction and operation of a golf course by a tribe was an "essential governmental function." See FSA 20024712 (Aug. 12, 2002). The FSA concludes that although the construction and operation of golf courses are customary government functions, "there is an argument that the commercial nature of the [tribal] Golf Course causes it to be other than an essential governmental function within the meaning of [Internal Revenue Code] section 7871(e)." The version of the FSA released at that time was heavily redacted to suppress the opinion of the IRS Chief Counsel questioning whether the IRS field agent's proposed challenge to the tax status of the tribe's bonds would ultimately be successful if litigated in the courts.

Since 2003, the IRS has opened a relatively large number of audits of tribal bond transactions. Initially, the IRS audits targeted tribes that had engaged in conduit bond transactions—i.e., transactions in which a state or local government agency not subject to the restrictive rules issues bonds for the benefit of a tribal governmental borrower. Shortly thereafter, the IRS opened up at least a dozen audits involving transactions in which tribes issued governmental debt directly for their own use. IRS agents made it clear that a major focus of these audits is to challenge the use of bonds to finance infrastructure or facilities that supported a tribe's gaming operations. IRS agents have also made statements in the press questioning the propriety of using bonds to finance recreational facilities for tribes with small memberships.

In June of 2004, an IRS Advisory Committee recommended that the IRS take the following constructive steps to facilitate a better understanding of applicable rules by tribal governments and other parties in the bond market:

- Request the Treasury Department to develop regulations defining “essential governmental function” under § 7871;
- Clarify that the term “essential governmental function” under § 7871(e) should be construed in accordance with its construction under IRC § 115;
- Withdraw FSA 200247012 [the golf course Field Service Advice described above] and suspend issuance of other nonprecedential guidance;
- Suspend any new compliance initiatives applicable to tribal bonds until after IRS regulations are issued.

See Advisory Committee on Tax Exempt and Government Entities (ACT): Report of Recommendations (June 9, 2004) (IRS Publication 4344(5-2004)).

The Report, prepared by Navajo Nation attorney Raymond Etcitty, concluded with the following plea: “How can tribal governments develop sustainable economies that produce recurring revenue needed to provide the infrastructure for their citizens, residents and visitors, when tribal governments have their hands tied behind their back?” Mr. Etcitty noted that the Treasury Department had failed to publish any regulations interpreting the tribal bond provisions since such provisions were amended by Congress in 1987.

A second IRS Advisory Committee report, prepared approximately one year later, reported that the issues identified in the 2004 report “continue to fester, and the frustration continues to grow as the IRS has significantly expanded the number of Tribes under audit as issuers or borrowers of tax-exempt debt.” The Committee concluded that “[t]hese audit actions collectively have had a perhaps intended chilling effect on issuance of tax-exempt tribal debt, and at the same time have reinforced sentiments of bias among Indian tribal governments and their advocates.” See Advisory Committee on Tax Exempt and Government Entities (ACT): Report of Recommendations (June 8, 2005), “Survey and Review of Existing Information and Guidance for Indian Tribal Governments.,” pp12-13 (prepared by Lenor Scheffler and Robert Gips).

Additional Federal Rules that Impose Costs on Tribal Issuers

Under current law, securities of tribal governments (e.g., tax-exempt bonds) are treated differently from securities issued by states or local governments. Obligations issued by state or local governments enjoy a general exemption from federal securities laws, except for the rules relating to fraud. By contrast, tribal securities are subject to registration under federal securities laws unless they have the benefit of a specific transactional exception—e.g., the exception for “private placements” or the exception for bonds that are backed by a bank letter of credit. Structuring a transaction to meet either one of these exceptions imposes transactional costs that particularly penalize small to medium-sized offerings. Issuing debt as a private placement will generally result in higher interest rates being paid by the tribe, while securing the backing of a bank letter of credit will also cost the tribe additional basis points in the transaction.

III. RECOMMENDATIONS FOR LEGISLATIVE CHANGE AND OVERSIGHT

There are a number of things that Congress can do to improve the current situation in which tribes are effectively prevented from accessing capital at the same rates and on the same terms as other governments. Some of these involve legislative changes. Others involve oversight to foster more effective and even-handed tax administration.

Legislative Changes

There are three possible legislative changes that would help tribes access capital in a more cost-effective manner. First, Congress should pass legislation repealing or modifying the “essential governmental function” test under Section 7871. Second, it should make some provision for private activity bonds – particularly with regard to affordable housing and energy projects financed by tribes. At the very least, Congress should gear the requirements of the tribal manufacturing facility exception to the real-life economics realities (including U.S. labor market costs) faced by 21st century manufacturing plants. Finally, although not within the jurisdiction of this Committee, Congress should provide tribes that issue bonds the same treatment under federal securities laws that it has accorded to state and local governments.

Repeal of the “essential government function” test is recommended because the last 20 years have demonstrated that the restriction is difficult to interpret and almost impossible to administer. These difficulties have resulted in an institutionalized bias against tribal governments as issuers of tax-exempt bonds and have erected insurmountable “barriers to entry” by tribes into the financial marketplace. Although the original purpose of the “essential governmental” function may have been to prevent tribes as bond issuers from being exploited by private parties, it has consistently been used against tribes acting in a government capacity and seeking to finance economic development within the boundaries of their own reservations.

Second, Congress should open up the general private activity bond prohibition to allow tribes to selectively issue bonds that would otherwise be considered private activity bonds. Such a provision would allow tribes to issue tax-exempt bonds for various types of facilities that serve a legitimate governmental purpose—such as facilities used by 501(c)(3) organizations, affordable rental housing, electric generation plants, water treatment, solid waste and sewage disposal plants. At the very least, Congress should closely examine and revise the provision that allows tribes to issue tax-exempt bonds to finance their own manufacturing facilities. The requirements of this provision must be made consistent with the economic realities of modern-day manufacturing in the United States. Legislation introduced in past Congresses by Senator John McCain and others would have allowed tribes to issue tax exempt bonds permitted to be issued by State and local governments under current law, so long as the tribe maintained at least a 50% ownership stake in the financed facility and satisfied a more flexible employment test.

Third, Congress should amend the Securities Act of 1933 to place bonds issued by tribal governments on par with those issued by state and local governments with respect to

federal securities registration requirements. The current lack of exemption serves no useful purpose and simply imposes extra transactions costs on tribal governmental issuances. Congress should also consider providing a special exception for certain tribal bonds from the "federal guarantee" prohibition. This prohibition generally comes into play where the governmental borrower relies on future federal assistance to repay the loan. It is largely irrelevant for gaming tribes with sufficient cash flow, but the provision creates problems for poor tribes and those with large memberships. Tax-exempt bond issuances of such tribes may fail to secure approval of bond counsel or underwriter's counsel because of the level of federal assistance being received by the tribe.

Need for Congressional Oversight

The disproportionate audit rate of tribal bond issuances suggests that some form of institutionalized bias against tribes as governmental issuers may have infected the IRS' administration of the tax laws. This situation needs further examination by this Committee and its staff. Congress should also examine whether IRS should conduct any audit initiatives in areas, such as this one, where Treasury has failed to issue adequate administrative guidance. The IRS should be asked to respond to the recommendations made in 2004 and 2005 by the IRS Advisory Committee on Tax-Exempt and Government Entities.

CONCLUSION

As Congress reviews tax policies affecting Indian country economic development, a tremendous opportunity exists to help tribal governments access the debt capital more cost-effectively. The proposed changes to the tax code would also eliminate current sources of confusion and controversy between taxpayers (in this case, tribal governments) and the IRS. Modification of the "essential governmental function" test has broad support among affected parties and by those national organizations that represent their interests, such as National Congress of American Indians (NCAI). The Cow Creek Band of Umpqua Tribe of Indians, together with NCAI, looks forward to working with you to develop and pass effective legislative solutions in this area.