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## Tax-Exempt Bonds

### **Proposed Test for Issuing Tribal Bonds Will Be Tough to Meet, Practitioners Say**

**A** practitioner said Sept. 6 that the three-part test the Internal Revenue Service is considering for determination of what constitutes an “essential governmental function” when tribal governments issue tax-exempt bonds will be difficult to meet.

IRS Aug. 9 issued an advanced notice of proposed rulemaking (REG-118788-06) that would define an essential governmental function as one that many state and local governments with general taxing powers have been conducting and financing with tax-exempt bonds; functions for which they have been using those types of bonds for many years; and activities that are not commercial or industrial in nature (153 DTR G-5, 8/9/06). Comments are due Nov. 7.

“There are some high hurdles the IRS is suggesting in interpreting ‘essential governmental function,’” Kathleen Nilles, partner with Holland & Knight, told BNA Sept. 6.

“If all that meant is that you are on a level playing field, and tribal governments should be able to do what state and local governments can do, it would be one thing,” she said, “but state and local governments are not subject to the same requirements, and the rules have been interpreted differently when applied to tribal governments.”

**Different Criteria.** State and local governments do not have to pass an “essential governmental function” test when they are issuing tax-exempt bonds, and they do not have to prove their use is for an activity that is not commercial or industrial, Nilles noted.

Under existing law, tribal governments can issue tax-exempt government bonds only if all the proceeds are substantially used for “essential governmental functions.” Native American governments want to be able to

finance infrastructure projects the same way local governments do, but have said they are hamstrung by ambiguity in the law and tax code (100 DTR G-12, 5/24/06).

Tribal governments are subject to added restrictions that state and local governments are not, Nilles said, namely Internal Revenue Code Section 7871, dealing with treating them as states, which restricts them to essential government functions “customarily performed” by state and local governments.” Having to prove that other governments are involved in these activities alone adds a level of due diligence, Nilles said, but even more prohibitive is the restriction on activities that are commercial or industrial.

State and local governments are involved in a host of construction projects financed by tax-exempt bonds, such as convention centers, parking garages, and golf courses, but tax-exempt financing for such projects by tribal governments is not always accepted by IRS.

**Acceptable Projects Specified.** The notice of proposed rulemaking made it clear that the acceptable projects will include, but are not limited to, the financing of schools, roads, and government buildings.

The proposed rules noted concerns by the House Ways and Means Committee that tribal governments are issuing tax-exempt bonds for interests in “commercial and industrial enterprises,” and therefore focused on infrastructures “customarily financed” by localities.

Lenore Scheffler, a Best & Flanagan attorney representing Native American governments, said some of her clients have expressed skepticism that IRS is really seeking feedback.

“I’m encouraging my tribal clients to comment,” she told BNA Sept. 6, because state and local governments’ ability to raise revenue [to finance projects] are very different from tribal governments.” But she said their concern is that what they have already seen in the notice is IRS’s position and not a true opportunity for comment.

BY DIANE FREDA