

**PRESENT LAW AND BACKGROUND RELATING  
TO TAX-EXEMPT FINANCING OF INDIAN TRIBAL PRISONS**

Scheduled for a Public Hearing  
Before the  
SENATE COMMITTEE ON FINANCE  
on September 21, 2004

Prepared by the Staff  
of the  
JOINT COMMITTEE ON TAXATION



September 20, 2004  
JCX-56-04

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## INTRODUCTION AND EXECUTIVE SUMMARY

### **Introduction**

The Senate Committee on Finance has scheduled a public hearing on September 21, 2004, relating to Indian tribal prisons. This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, includes a description of present law and background relating to the authority of Indian tribal governments to issue tax-exempt bonds for Indian tribal prisons.

### **Executive Summary**

An Indian tribal prison or other detention facility may be financed with tax-exempt bonds issued by an Indian tribal government to the extent the construction and use by an Indian tribe of such facility is an essential governmental function of the tribe. Such bonds, however, would be subject to the restrictions on private activity bonds under section 7871 of the Internal Revenue Code (the “Code”), including limitations on the amount of private business use and private payments or security with respect to bond-financed facilities.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background Relating to Tax-Exempt Financing of Indian Tribal Prisons* (JCX-56-04), September 20, 2004.

## PRESENT LAW AND BACKGROUND

### A. Tax-Exempt Bonds Issued by State and Local Governments

Generally, interest on obligations issued by a State or local government is excluded from gross income.<sup>2</sup> For these purposes, the term “State or local government” includes a State, territory, possession of the United States, the District of Columbia, or any political subdivisions of those entities.<sup>3</sup>

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person (“private activity bonds”) is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue act. The term “private person” includes the Federal government and all other individuals and entities other than States or local governments.

The determination of whether a bond is a private activity bond is based on (1) the amount of bond proceeds used for private business uses (and corresponding private payments or security involved) or (2) the amount of loans made to private parties (whether or not business parties) with the proceeds. In general, a bond is a private activity bond if there is more than 10 percent private use and private payments or security with respect to the bond-financed facility. The private loan limit equals the lesser of five percent or \$5 million.

### B. Tax Treatment of Indian Tribal Governments

#### In general

Indian tribes are not States or subdivisions of States, but “distinct, independent political communities, retaining their original natural rights in matters of local self-government.”<sup>4</sup> Congress, however, is granted broad authority under the Constitution to legislate in the field of Indian affairs.<sup>5</sup> As a result, the right of tribal self-government is generally “dependent on and subject to the broad power of Congress.”<sup>6</sup>

In 1982, Congress passed the Indian Tribal Governmental Tax Status Act (the “Tribal Tax Act”) that added certain provisions to the Code that pertain to the status of Indian tribal governments.<sup>7</sup> Section 7871(a) of the Code provides that Indian tribal governments (or

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<sup>2</sup> Sec. 103.

<sup>3</sup> Treas. Reg. sec. 1.103-1(a).

<sup>4</sup> *Santa Clara Pueblo v. Martinez*, 436 U.S. 49, 55 (1978).

<sup>5</sup> *United States v. Lara*, 541 U.S. \_\_\_, 124 S. Ct. 1628, 1633 (2004).

<sup>6</sup> *White Mountain Apache Tribe v. Bracker*, 448 U.S. 136, 143 (1980).

<sup>7</sup> Pub. L. No. 97-473 (1983).

subdivisions thereof) will be treated as States for certain enumerated Federal tax purposes. For example, charitable contributions to or for the use of a tribal government may be deductible under the Federal income, gift, and estate tax laws; a tribal government is entitled to exemption from certain excise taxes; taxes imposed by a tribal government may be deductible; and, subject to certain requirements, obligations issued by a tribal government may be tax-exempt. The Code defines the term “Indian tribal government” as the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is determined by the Secretary of the Treasury, after consultation with the Secretary of the Interior, to exercise governmental functions.<sup>8</sup>

### **Tax-exempt bond issuance authority**

Prior to the Tribal Tax Act, the Internal Revenue Service (the “Service”) had taken the position that any obligations issued by a tribal government were not tax-exempt because tribes are neither States nor political subdivisions within the meaning of section 103.<sup>9</sup> However, with the adoption of the Tribal Tax Act, Congress recognized that tribal governments often have needs similar to State and local governments and should have the ability to issue tax-exempt bonds to finance governmental functions.<sup>10</sup> Accordingly, the Tribal Tax Act provided tribal governments with the authority to issue tax-exempt bonds, but placed limitations on this authority. The authority of Indian tribal governments to issue tax-exempt bonds is set forth in section 7871 of the Code. Generally, that provision permits Indian tribal governments to issue tax-exempt bonds to finance only activities that are essential governmental functions. With the exception of financing for certain manufacturing facilities, Indian tribal governments may not issue private activity bonds. Thus, no person other than the issuing Indian tribal government may use the bond proceeds (and be responsible for debt service on the bonds) in a manner resulting in violation of the private business use and private payment or security tests that determine generally whether a bond is a private activity bond.

In 1984, Treasury regulations were issued under section 7871 interpreting the term “essential governmental function.”<sup>11</sup> The regulations provide that an essential governmental function of an Indian tribal government is a function of a type that is: eligible for funding under the Snyder Act,<sup>12</sup> which governs the general appropriations of the Bureau of Indian Affairs (“BIA”); eligible for grants or contracts under certain provisions of the Indian Self-Determination Act;<sup>13</sup> or an essential governmental function under section 115 of the Code.

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<sup>8</sup> Sec. 7701(a)(40)(A).

<sup>9</sup> Rev. Rul. 68-231, 1968-1 C.B. 48 (1968), declared obsolete by, Rev. Rul. 86-44, 1986-1 C.B. 376 (1986).

<sup>10</sup> S. Rep. No. 97-646 (1982).

<sup>11</sup> Temp. Reg. sec. 305.7871-1(d).

<sup>12</sup> 25 U.S.C. sec. 13.

<sup>13</sup> 25 U.S.C. secs. 450f and 450h.

Because of concerns that Indian tribal governments were issuing bonds for purposes that were commercial, rather than governmental in nature, Congress provided additional limitations on Indian tribal governments' authority to issue tax-exempt bonds as part of the Omnibus Budget Reconciliation Act of 1987 (OBRA).<sup>14</sup> Congress mentioned private rental housing, cement factories, and mirror factories as examples of activities that are beyond the scope of the definition of essential governmental functions. Moreover, the legislative history of OBRA specifically rejected the Treasury regulations under section 7871, stating that the fact that BIA "may provide Federal assistance for Indian tribal governments to engage in commercial and industrial ventures . . . is not intended to be determinative . . . [and] regulations that may infer a contrary result are to be treated as invalid."<sup>15</sup>

In addition, a new subsection (e) was added to 7871 to provide that the term "essential governmental function" includes only those activities customarily performed by State and local governments with general taxing powers. Schools, roads, and government buildings are listed in the legislative history as examples of activities that are customarily financed with governmental bonds.<sup>16</sup> The Service has taken the position in a private letter ruling that the financing and construction of jail and court facilities are essential governmental functions of States and local governments within the meaning of section 115.<sup>17</sup>

Thus, a prison or other detention facility may be financed with tax-exempt bonds issued by an Indian tribal government to the extent the construction and use by an Indian tribe of such facility is an essential governmental function of the tribe. Such bonds, however, would be subject to the restrictions on private activity bonds under section 7871, including limitations on the amount of private business use and private payments or security with respect to a bond-financed facility.

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<sup>14</sup> Pub. L. No. 100-203 (1987).

<sup>15</sup> H.R. Rep. No. 100-391, at 1139 (1987). The Treasury has not amended Temp. Reg. sec. 305.7871-1 to reflect changes made by Pub. L. No. 100-203.

<sup>16</sup> *Id.* at 1139.

<sup>17</sup> Priv. Ltr. Rul. 9025062 (Mar. 27, 1990).