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Tribal Business Formation -- Legal and Structural Options

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Overview

- Key Factors in Choosing a Structure
- Available Types of Corporate and Governmental Structures
- Pros and Cons of Each Structure
- Special Considerations Applicable to Joint Ventures

Key Factors to Consider

- Organizational Considerations
  - Ease of Formation
  - Governance and Management
- State and Federal Tax Treatment
  - Income Tax Immunity of the Entity
  - Availability of Tax Incentives for Project
  - State Income and Sales Taxes

Key Factors To Consider (continued)

- Facilitating Financing/Access to Capital
- Immunity and Limitation of Liability
  - Protection of Tribal Assets through Sovereign Immunity
  - Limitation of Liability For Non-Tribal Owners
  - Resolution of Disputes (choice of law, forum, etc.)

Three Types Of Governmental Entities

- Tribal Government
- Unincorporated Agencies, Divisions, Enterprises and Instrumentalities of the Tribal Government
- Political Subdivision of Tribal Government

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Tribal Government As A Business Entity

- Tribes have inherent rights of self-government, including the power to engage in business
- Easy to organize, but no separation of business from politics
- IRS has consistently ruled that the Tribe is not a taxable entity
  - Income derived from any business operated directly by a Tribe (on or off Tribe’s reservation) will be tax free
  - But federal excise tax exemptions are generally limited to essential governmental functions

Tribal Government As A Business Entity

- Federally recognized Indian tribal governments (ITGs) also have <u>some</u> access to tax-exempt or tax-favored financing
  - Tax-exempt bond financing authority (use is generally limited to essential governmental functions)
- Clean renewable energy bonds ("CREBs) and Tribal Economic Development Bonds ("TEDBs) (use not limited to essential governmental functions, but Tribe must <u>apply</u> to Treasury for an allocation)

Unincorporated Agencies, Divisions and Instrumentalities

- Tribe may operate a business enterprise tax-free through an agency, unincorporated division, or an instrumentality – i.e., as an arm of Tribal government and not a distinct legal entity

- Generally, these governmental units are formed under tribal law for governmental purposes

- Share the same legal characteristics as the tribal government

Unincorporated Agencies, Divisions and Instrumentalities (Management)

- These governmental units are usually controlled by the tribal government and its tribal council
- May have a board of directors, which is usually comprised of tribal council members and others
- Manager in charge of day-to-day activities

Unincorporated Agencies, Divisions and Instrumentalities (Immunity)

- Just as Indian tribes have sovereign immunity from lawsuits, a governmental unit that serves as the tribe's economic arm has the same immunity
- Consequently, these units cannot be sued absent a clear waiver of immunity
- Immunity can create uncertainty and risks for nontribal partners and lenders

Unincorporated Agencies, Divisions and Instrumentalities (Tax Treatment)

- IRS has consistently ruled that the Tribe is not a taxable entity (Rev. Rul. 94-16)
- Tribal governmental units have been treated the same as tribes because they are not a separate legal entities
- There is no specific exemption for business enterprises wholly-owned by Tribes

Unincorporated Agencies, Divisions and Instrumentalities (Tax Treatment)

- When determining tax treatment of an instrumentality, the IRS looks at the following:
  - Governmental purpose or function
  - Performance of function on behalf of the tribal government
  - Whether the tribal government has the power and interest of an owner

Unincorporated Agencies, Divisions and Instrumentalities (Tax Treatment)

– Control and supervision by tribal government
– Statutory authority for the instrumentality's creation and operation
– Degree of financial autonomy and source of operating expenses

Pros and Cons

- Advantages of using government enterprise:
  - Relative certainty of tax treatment
  - Same federal privileges and immunities as tribe
  - Access to federally subsidized financing (including tax-exempt and/or tax-credit bonds)
- Disadvantages:
  - Governance issues (e.g., some mixing of business and politics)
  - Requirements of partners and lenders

Political Subdivisions

- A political subdivision is a unit of the tribal government that:
  - Is separate from the government to some degree
  - Has been delegated a sufficient amount of one or more recognized sovereign powers of the tribe
  - Created under tribal law to fulfill a substantial governmental function of the government (e.g., a utility that performs regulatory functions)
  - Has same tax-free status (and sovereign immunity) as the Tribe

Political Subdivisions (continued)

- Tribal political subdivision must exercise one or more sovereign powers: E.g., the power to tax, power of eminent domain, and power to regulate
- Per Rev. Proc. 84-37, there are two steps to confirming a political subdivision's status
  - Secure a letter from DOI verifying that the Tribe has delegated a substantial government power
  - Once the letter has been issued, file IRS ruling request

Political Subdivisions (continued)

- IRS treats political subdivisions the same as the tribe -- so long as they are delegated substantial government powers
- Political subdivision shares in other tax benefits under IRC 7871
  - Tax-exempt bond authority and other tax-favored financing
  - Excise tax exemptions

Pros and Cons

- Advantages of a political subdivision
  - Relative certainty of federal tax treatment
  - Possible retention of state tax immunity
  - Sovereign Immunity
  - Can use a political subdivision as both a regulatory body and as a business holding company
  - Availability of federally subsidized financing, such as Tribal Economic Development Bonds (“TEDBs”)

Pros and Cons (continued)

- Disadvantages of a political subdivision
  - Time and expense of formation, including dual federal agency approval
  - Not as flexible as a regular business entity
  - Business partners may not be comfortable dealing with a governmental entity

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Tribal Business Corporations

- Federal Law Corporations
- State Law Corporations
- Tribal Law Corporations

Federal Law Corporations

- Sec. 17 of Indian Reorganization Act (IRA)
  - Formerly available only to tribes that had elected to organize their government under the IRA, but since 1990, available to non-IRA tribes
- Sec. 3 of the Oklahoma Indian Welfare Act
- Can be utilized as an operating company or a holding company for one or more tribal subsidiaries (including an energy business)

Section 17 Corporation

- Indian tribes must take the following five steps to organize and secure BIA approval of a federally-chartered Section 17 corporation:
  - Tribal Resolution or Petition
  - Draft Charter
  - Approval by the Tribe
  - Filing of Petition/Resolution with Department of Interior
  - Ratification of Corporate Charter

Section 17 Corporation (Management)

Federally-chartered corporations are separate legal entities that share the tribe's tax status and immunity

- Must be wholly-owned by the tribal government (generally, <u>no</u> private ownership)
- Managed by a corporate board appointed by the tribal council with a CEO/manager in charge of day-to-day operations

Section 17 Corporation (Immunity)

- Corporation has same privileges and immunities as the tribe--including immunity from suit
- Section 17 charter must contain a “sue and be sued clause” permitting it to be sued in its corporate name
- Sovereign immunity waiver should be limited to corporate sovereign immunity and/or specific transactions entered into by the Section 17 corporation

Pros and Cons

- **Advantages**
  - Same federal tax treatment as Tribe
  - Segregates assets and liabilities of business from tribal assets
  - If properly organized, a Section 17 corporation is immune from suit, but may waive immunity
  - 25 year leasing authority
    - Section 81 approval not necessary for leases or mortgages of tribal land

Pros and Cons (continued)

- **Disadvantages**
  - Charter approval process may be lengthy
  - Once a charter is issued by the Department of Interior (DOI) it can only be revoked by Congress
  - Business partners and lenders may be unfamiliar with federal chartering (e.g., no accessible DOI database of approved charters)
  - Availability of financing (e.g., not a qualified issuer of CREBs, but may be viewed as an integral part of Tribe)

State Law Corporations

- Corporation formed under state business or nonprofit corporation laws
- May be wholly owned and controlled by tribe, or organized as joint venture
- Because it is subject to state corporate law, it will most likely be unable to assert tribe's sovereign immunity

State Law Corporations (continued)

- Taxable if incorporated under state law
  - Rev. Rul. 94-16 -- state-law corporation with Tribe as sole shareholder not tax-free
  - PLR 9826005 - wholly-owned nonprofit health corporation not an integral part of Tribe where formed under state law
- States can form state-law corporations that qualify as “integral parts,” but tribes cannot (under IRS guidance issued to date)

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Pros and Cons

- **Advantages** of State-law corporations
  - Easily and quickly organized
  - Familiar to lenders and potential business partners
  - May facilitate a merger
- **Disadvantages**
  - Subject to federal income tax
  - Not a qualified issuer of tax-exempt financing
  - Not likely immune from suit

Tribal Law Corporations

- Tribal law corporations are formed under a tribe's corporate code
- Relatively easy to establish, as compared to federally chartered corporations
- Tribal law corporations, unlike state law entities, are more likely to be free from state regulation (so long as business operations are confined to reservation)

Tribal Law Corporations (Management)

- Tribal law corporations are managed and overseen by a corporate board that is elected by the corporation's shareholders (e.g., the Tribe, if the corporation is wholly owned)
- Directors approve budgets, approve the hiring and firing of setting compensation for senior officials, and establish a business strategy
- A CEO or executive director manages the day-to-day operations of the corporation

Tribal Law Corporations (Tax Treatment)

- Since 1994, tax status has been uncertain
  - Rev. Rul. 94-16 did not address
  - In 1996, classification of entity regulations did not address, but preamble noted that Treasury and IRS were studying issue
- In 2001, Treasury/IRS agreed to resolve the uncertainty.
  - Progress on the pending IRS guidance has been slow

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Tribal Law Corporations (Tax Treatment)

- IRS could take one of three approaches
  - Per se approach (treat like Section 17 corps)
  - Facts and circumstances approach
  - Treat like state chartered corporation (negative per se)
- Integral Part Factors (IRS Version)

  --substantial governance control

  --significant financial commitment

Tribal Law Corporations (Tax Treatment)

- “Integral Part” test is also used to determine tax treatment of state and local government-owned business entities
- IRS has enlarged its pending guidance to cover all government-owned corporations
- However, while the new proposed regulations are being formulated, the IRS has stopped issuing “integral part” rulings. Thus, tax uncertainty persists.

Pros and Cons

- Advantages of tribal law corporations
  - Ease of formation
  - An exercise of sovereignty; less likelihood of state regulation (?)
  - Flexibility
  - Possible tax immunity (if integral part of Tribe)

Pros and Cons (continued)

- Disadvantages
  - Uncertainty of federal tax treatment
  - Business partners may not be comfortable
  - Uncertainty of sovereign immunity
  - Availability of financing

Another Option:
Limited Liability Company (LLC)

- An increasingly popular choice of business entity, commonly used for energy projects
- LLCs provide their owners with limited liability (like a corporation) but are not subject to double taxation
- Generally, formed under state law, but may also be formed under tribal law; if subject to state law, no sovereign immunity

Another Option:
Limited Liability Company (LLC)

- Formation requirements are similar to those applicable to corporations
  - Can be quickly and easily organized under the laws of most states (or a tribal LLC code)
  - Must select a name and file a document similar to a corporation's Articles of Incorporation
- May be wholly owned/controlled by tribe, or it may be organized as a joint venture

Limited Liability Company (Tax Treatment)

- Federal tax treatment of LLCs is provided for under the Treasury Regulations, which are sometimes referred to as the “check-the-box” regulations
- If owned by two or more members, taxed like a partnership; if wholly-owned, “disregarded” as a separate legal entity
- May elect to be taxed as a corporation

Single-Member (“SM”) LLCs

- State and local government SM LLCs are treated like corporations under IRS regulations; IRS has also extended the per se corporation rule to foreign government SM LLCs
- So far, IRS has not extended this rule to tribal SM LLCs
- Most advisors believe that tribal government SM LLCs should continue to be treated as disregarded entities under current law, but IRS could change the rules (prospectively)

Limited Liability Company (Sovereign Immunity)

- Under state LLC codes, an LLC’s liability is limited to the assets of the company, thereby protecting the owners or members
- At least two courts have suggested that a tribe’s sovereign immunity does not extend to its wholly-owned state-law LLCs

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Pros and Cons of LLCs

- **Advantages**
  - Easily and quickly organized
  - Familiar to lenders and potential business partners
  - Can be used to acquire or merge with an existing state-law entity
  - Availability of private financing

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Pros and Cons of LLCs (continued)

- **Disadvantages**
  - Probably not immune from suit
  - Future taxation is somewhat uncertain
  - Federally subsidized financing, such as tax-exempt bonds and tax-credit bonds, may not be available

S Corporations

- S corporations are also used to achieve a single level of tax
- Not a viable option for tribal ownership
  - Tax Code restricts S Corp ownership to individuals, estates, trusts, pension plans and charitable organizations.
  - Rev. Rul. 2004-50 clarifies that a tribal government is not a qualified S corp. shareholder

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Joint Ventures

- Choice of entity
  - Corporation (generally not tax-efficient)
  - Partnership (flow-through tax treatment)
  - LLC (same as partnership)
- Formation (choice of law)
  - State
  - Tribal

Joint Ventures (continued)

- As previously discussed, an LLC can be easily and quickly organized
- To organize, must select a name and file a document that is similar to a corporation's Articles of Incorporation

Joint Ventures (continued)

- May also form JV as a general or limited partnership
- General partnerships are easily organized (do not even have to file with the state), but each partner assumes liability for the activities of the organization

Joint Ventures (continued)

- Limited partnerships have one or more limited partners and at least one general partner
  - Limited partners are protected against personal liability for the partnership's activities
  - Limited partners cannot participate in the management and control of the business
  - General partner assumes liability for the partnership's business activities
  - General partner manages and controls the business

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Joint Ventures (continued)

- Considerations common to LLCs and LPs
  - Whether to own the JV interest directly or through an intermediary business entity
  - Because of the tribe’s sovereign immunity and other uncertainties, business partners may prefer that the tribe hold its interest through a separate business entity
  - Sovereign immunity does not extend to the JV itself
  - But JV can be structured to minimize liability of owners

Joint Ventures (continued)

- Considerations common to LLCs and LPs (continued)
  - A JV would not be able to issue tax-exempt bonds or CREBs or use the proceeds of such an offering
  - Types of financing available
    - Private placements
    - Commercial bank financing
    - Government-guaranteed loans (depending on JV's line of business)

Joint Ventures
(Tax Treatment)

- Under IRS regulations, an LLC with two or more members is treated as a partnership
- If a Tribe is a member of a partnership, it will not be taxed on its share of income
- JV partners can structure how deductions and tax credits are allocated – but only within limits
  - "Substantial economic effect" constraint
  - Tax-exempt entity leasing rules

Pros and Cons

- **Advantages** of conducting business through a jointly-owned LLC or LP:
  - Ease of formation
  - Flexibility (relative ability to design own governance structure
  - Flow-through taxation, which results in
    - Tribe's share of the JV's income being tax-free
    - Other partner's share of tax benefits (e.g., deductions, credits) being available to it

Pros and Cons (continued)

- **Disadvantages:**
  - Likely loss of sovereign immunity
  - Inability to qualify for certain types financing
  - Difficulties in unwinding the JV if one party wants to terminate
  - Complicated tax rules apply if parties make disproportionate allocations of tax credits or other tax benefits

Question and Answers?

- For more information, please contact:

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