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# TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES

## HEARING

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

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# TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES

**TUESDAY, MAY 15, 2012**

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Max Baucus (chairman of the committee) presiding.

Present: Senators Bingaman, Cantwell, Menendez, and Hatch.

Also present: Democratic Staff: Russ Sullivan, Staff Director; Lily Batchelder, Chief Tax Counsel; Richard Litsey, Counsel and Senior Advisor for Indian Affairs; Ryan Abraham, Tax Counsel; Tiffany Smith, Tax Counsel; and Jeff VanderWolk, International Trade Counsel. Republican Staff: Chris Campbell, Staff Director; Tony Coughlan, Tax Counsel; and Nick Wyatt, Tax and Nominations Professional Staff Member.

## OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will come to order.

There is a Crow proverb that says, "Man's law changes with his understanding of man. Only the laws of the spirit remain always the same."

Our desire to spur broad-based economic growth and give help to those who need it stays the same, but our laws are ever-changing. And, while some are well-intentioned, the 15,000 changes made to the tax code since 1986 have created too much complexity and unfairness. Tax reform needs to simplify the code in a way that creates jobs and encourages growth.

Today we will look at tax reform and how it affects Indian tribes and the United States' five territories—Puerto Rico, U.S. Virgin Islands, Guam, American Samoa, and the Northern Mariana Islands.

Indian governments and the territories are in some ways similar to State governments: each provides hospitals, public schools, and law enforcement, for example. But U.S. policies do not recognize tribal governments or territories as States or fully sovereign nations. Instead, U.S. law has a patchwork of complicated rules for each territory. Every tribal government's U.S. policies are inconsistent.

Tax policy is a microcosm of this inconsistency. The unemployment rate on some reservations, such as the northern Cheyenne reservation in Montana and the Pine Ridge reservation in South Dakota, is 80 percent. One in four Indians lives below the poverty

line. American Indians' median income is 31 percent less than all other Americans. U.S. territories and commonwealths also suffer from high unemployment.

In the past, Congress has recognized the special status of tribal governments and the island territories and taken steps through our tax policies to improve their economic conditions. We provided accelerated depreciation for capital investments and an employment credit for businesses located in Indian country. Congress also allowed businesses to claim a credit for the production of coal from Indian land.

The accelerated depreciation provision brought jobs and economic activity to the Crow tribe in Montana when Westmoreland Coal used it to boost profits. But there are issues with these provisions. Two-thirds of the State of Oklahoma qualifies as an eligible Indian reservation under the accelerated depreciation provision and employment tax credit; perhaps the tax laws need to be better targeted.

Congress should also level the playing field for tax-exempt bonds. States are currently allowed to issue tax-exempt bonds for any public purpose. These bonds help governments access cheap capital to build schools or courthouses. States can also use them to finance tourism and economic development projects like municipal golf courses, convention centers, and hotels.

In contrast, tribal governments can only issue bonds for government buildings. Their bonds have to pass what is called an "essential government" test. To address this inequity, in 2009 Congress authorized $2 billion of tribal economic development bonds for any purpose other than gambling facilities. The Treasury Department studied the program, and it recommended that Congress repeal the essential government test. We should do this as part of tax reform.

Another area of concern for tribal governments is the application of the general welfare doctrine. This doctrine allows governments to provide benefits to citizens without those benefits counting as taxable income.

Tribes provide many benefits to their members, including educational assistance and cultural awareness, along with housing and meals. But it is often unclear which benefits are eligible for the exemption. That uncertainty is tough on families and tribal governments, and it is something we should fix.

For U.S. territories, Federal tax law previously contained an economic activity tax credit and a possessions tax credit to encourage investment. These credits expired at the end of 2005. Another provision set to expire sends a portion of excise taxes on rum to two territories to help fund their government operations.

Today's hearing provides an opportunity to consider these issues in the context of broader tax reform. I hope today's witnesses will help us understand what roadblocks should be eliminated and what incentives work for Indian country and for the territories.

When I talk with tribes in Montana, they tell me the same thing: they want a better future for their children and less reliance on the Federal Government. These are goals we share.

So let us use tax reform as an opportunity to achieve these goals. Let us think outside the box. Let us be creative here. Let us hear what might be done to help tribes and territories meet their goals.

And, in the spirit of the Crow proverb, let us take this opportunity to make man's law reflect our common desires.

[The prepared statement of Chairman Baucus appears in the appendix.]

The CHAIRMAN. Senator Hatch?

**OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH**

Senator HATCH. Well, thank you, Mr. Chairman. This hearing deals with, as you said, two very important, yet distinct, subject topics: tribal tax issues and territory tax issues. I want to stress that I do not come into this hearing with any pre-conceived agenda as to how we ought to treat tribes and territories. Rather, we must consider how we can be most productive on these matters when we undertake fundamental tax reform.

With respect to tribal tax issues, certain of them, such as the general welfare exclusion, seem to have been outstanding for several years. This committee needs to determine the scope of actions to be taken when final tax reform is finally realized.

Aside from the long-term implications for tax reform, there are short-term questions concerning the subject matter of today's hearing. Several so-called tax extenders explicitly designed to aid Native American tribes, such as accelerated depreciation for business property on Indian reservations, have actually expired. A credit for the production of Indian coal will expire at the end of this year. If we are going to break out of the repetitive loop of short-term extensions, we should not put off a discussion of these temporary measures, even prior to comprehensive tax reform.

I am also interested to hear about the tax treatment of territories. In a nutshell, even though the people of the various possessions are United States citizens or nationals, most do not pay tax to the Federal Government but rather to their possession's government.

Some U.S. possessions have a mirror tax code with tax laws essentially identical to the U.S. Internal Revenue Code, simply swapping the name of the possession wherever the Internal Revenue Code says "United States." Yet, others are given more autonomy to write their own tax laws as they see fit.

In some ways, possessions are treated like foreign countries. In other ways, however, they are treated like States. For example, research and development in a territory is eligible for the R&D credit, just as if the R&D were performed in a U.S. State. However, income taxes paid to a possession's government are generally eligible for a U.S. foreign tax credit, just as if paid to a foreign government. Of course, taxes paid to a State government are not creditable, and only sometimes deductible.

I will be interested in understanding whether greater consistency in the tax treatment of possessions is desirable or feasible. Now, I do share the chairman's dedication to thoroughness that this committee's tax reform hearings represent and the emphasis they place on technical knowledge, and I expect that this hearing will make a worthy contribution to that particular effort.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

[The prepared statement of Senator Hatch appears in the appendix.]

The CHAIRMAN. I would now like to introduce our four witnesses. First is Ms. Sarah Ingram. Ms. Ingram is the Commissioner for Tax Exempt and Government Entities at the Internal Revenue Service. Thank you for coming. We will be asking some questions. Next, the Honorable Robert Porter, president of the Seneca Nation of Indians. Thank you, Mr. President, for being here. Our third witness is Dr. Lindsay Robertson, professor of law at the University of Oklahoma. Finally, Dr. Steven Maguire, a Specialist in Public Finance at the Congressional Research Service. Thank you all very much for coming.

You probably know our usual practice here is, your statement is automatically included. You may each speak about 5 minutes. I say this all the time and keep on saying it: do not pull any punches, say what you think, be candid. You cannot take it with you. Tomorrow is gone after today. [Laughter.]

So, Ms. Ingram?

**STATEMENT OF SARAH HALL INGRAM, COMMISSIONER, TAX EXEMPT AND GOVERNMENT ENTITIES, INTERNAL REVENUE SERVICE, WASHINGTON, DC**

Ms. INGRAM. Thank you. Good morning, Chairman Baucus, Ranking Member Hatch, and members of the committee. I appreciate the opportunity to be here to discuss the general welfare exclusion as it applies to tribal programs and to discuss tribally issued tax-exempt bonds.

As I begin, I want to acknowledge that the United States has a unique government-to-government relationship with the Indian tribes, as set forth in the Constitution of the United States, treaties, statutes, executive orders, and court decisions.

The Office of Indian Tribal Governments within the IRS was created more than a decade ago in response to requests by tribal leaders. The office exists to facilitate the government-to-government relationship and to assist tribes in meeting their Federal tax obligations.

First, I would like to address the general welfare exclusion. Tribes, like all governments, sponsor programs designed to support their members. To be very clear, whether this tax exclusion is or is not applied does not limit what benefits or social programs tribes can provide to their members. The question is whether payments made through these programs are excludable from the income of the recipient under the general welfare doctrine.

There are two key tax concepts. First, code section 61 provides that gross income includes all income derived from whatever source, and the second, the general welfare exclusion, is a non-code exception, an administrative exclusion that has been developed in official IRS guidance and recognized by the courts and Congress over more than 50 years.

Despite the statutory breadth of section 61, the administrative rulings show that payments made by governmental units, tribal or non-tribal, can be excluded from a recipient's gross income under the general welfare doctrine, if the payments: (1) are made under a governmental program; (2) are for the promotion of general wel-

fare generally based on individual, family, or other needs; and (3) do not represent compensation for services.

The IRS does not have, and has never had, a special program for examining tribal governments' social welfare programs. The question may arise if the tribe seeks a letter ruling about a specific program. It can also arise during an IRS review of tribal governments' tax reporting compliance.

The code requires all persons, including Indian tribal governments, to report to the IRS certain payments of $600 or more. During an examination, records may show such payments to tribal members, requiring further inquiry as to whether the general welfare exclusion applies, because, if so, then the amounts do not have to be reported.

The IRS always examines a program using the same 3-prong analysis. Comments from the tribal community have focused on whether the payments are being disbursed based on the needs of the recipient and on the issue of whether the payments constitute compensation received for services.

While there are many tribal and non-tribal examples in administrative rulings, the difficulty has been that each application is fact-specific, and the historical and cultural context within the tribal government environment adds a layer of complexity.

In response to concerns raised by various tribes and tribal leaders, the IRS issued Notice 2011–94 last November, inviting comments concerning the application of the general welfare exclusion to Indian tribal government programs and beginning a specific consultation process with tribes on how to find a solution that addresses their concerns and improves clarity and consistency of the tax law.

Since then, the IRS has received numerous written comments from tribes and tribal leaders, which we are carefully reviewing, and the IRS and Treasury have engaged in multiple consultation sessions, such as in November during the White House Tribal Nations Conference, in March during the National Congress of American Indians' Annual Conference, and in a few weeks we will host another consultation session through teleconference to facilitate participation.

The IRS plans to publish written guidance that will address issues and respond to concerns raised by tribes in their oral and written comments. Our intent is that this published guidance, along with improved internal coordination procedures, will provide increased clarity and consistency of the application of the general welfare doctrine. Tribal concerns are very important to us, and we look forward to continuing to work with tribes on this item in the future.

My second topic is tribally issued tax-exempt bonds. In the interest of time, I would like to refer the committee to my written testimony, with just two notes. I would note that we are taking into account recent community input on the usage of American Recovery and Reinvestment Act Tribal Economic Development Bonds, and we expect to publish revised procedures to reallocate the unused amounts.

Also, as requested by Congress, Treasury provided a report last December containing legislative proposals to facilitate the use of

bond financing by tribal governments under rules more closely parallel to those applied to State and local governments.

I am aware of the administration's commitment to strengthen and build the government-to-government relationship between the United States and tribal nations, and I appreciate the committee's interest in these matters.

Thank you. That concludes my testimony. I would be happy to take any questions.

The CHAIRMAN. Thank you, Ms. Ingram, very much.

[The prepared statement of Ms. Ingram appears in the appendix.]

The CHAIRMAN. President Porter?

**STATEMENT OF HON. ROBERT ODAWI PORTER, PRESIDENT, SENECA NATION OF INDIANS, SALAMANCA, NY**

President PORTER. Nya-weh Ske-no. Mr. Chairman, Vice Chairman Hatch, Senator Bingaman, Senator Cantwell, I am honored to be here, and I am thankful that you are all well.

I am here to testify on the promise of tax reform for American Indian Nations and ask that my written testimony be placed into the record.

[The prepared statement of President Porter appears in the appendix.]

President PORTER. I am here today on behalf of the Seneca Nation of Indians, which I serve as its elected president. The Seneca Nation is one of America's earliest allies, historically aligned with the other members of the six nations of the Haudenosaunee Confederacy and living in peace with the American people since the signing of the Canandaigua Treaty 217 years ago.

In that treaty, the United States promised that it would recognize the Seneca Nation as a sovereign nation, that it would ensure that our property and activities would not be taxed, and that it would forever secure our title to our lands. This treaty belt that I hold up, the "Guswhenta," or the Two Row Wampum belt, is a symbol of the continued recognition and respect that we agreed to hundreds of years ago.

Because of our treaty-protected freedoms, the Seneca Nation has been able to achieve some economic success in recent years, mainly as a result of our commerce with non-Indians involving tobacco, gaming, and other related ventures. I encourage this committee to shape its tax reform effort for all Indian nations so that it maximizes our freedoms, which are premised upon treaties and territorial tribal sovereignty.

In the Seneca Nation we have long believed that our treaties with the United States require that the Seneca Nation, our people, our activities, and our lands be treated as immune from all Federal and State taxation. However, many aspects of our treaty-recognized freedoms have been eroded over time, including tax burdens imposed by external governments which have diverted wealth from our territories and made much of Indian country unattractive for investment.

For specific analysis of several areas of concern to Indian country, I draw your attention to the excellent comments that have been submitted by the United South and Eastern Tribes and the

National Congress of American Indians. As a general matter, however, if tax reform is to work in Indian country, it must be, first, consistent with the principles that are at the foundation of Indian policy at its best.

The tribal nations are governments whose exclusive authority is to govern all economic activity in our territories, and that is fully respected as a matter of Federal law. Resurrecting this tribal territorial sovereignty approach must be the focus of congressional tax reform efforts if they are to succeed.

In recent decades, tax reform ideas, like the Indian Reservation Wage and Investment Tax Credits, have not been large enough, have not been of long enough duration, or have not even been as simple to administer as necessary to induce the private sector to invest and locate new jobs in Indian country. Because these proposals have made all of Indian country eligible, in theory the budget-scoring rules that estimate the costs of these reforms have led Congress to water down their benefits to useless levels.

Many of the good people in this room have worked hard at tax reform ideas in the past. They sincerely thought that they would bring benefit to Indian country. But these complex schemes mainly created work for lawyers, accountants, consultants, and government administrators. With all due respect, they have produced little tangible benefit for Indian country. If you drive through most Indian territories in the Great Plains or anywhere else, you can see the evidence of the poverty that makes the undeniable point that these incentives have not worked.

As you shape tax reform in Indian country, I urge you to keep it simple so that it can be implemented without Indian people having to hire an army of expensive lawyers, accountants, and consultants. Keep it simple so that local businesses and potential investors can make sense of it and generate jobs for native people.

In my view, the accumulated decades of Federal tax policy failures in Indian country make the case for trying something bold and different based upon our aboriginal treaty relationship. Instead of dialing back potential tax incentive benefits to useless levels, I urge you to recognize unlimited tax immunity on a limited number of footprints in Indian country for a limited number of Indian nations. In other words, I suggest that you shape tax reform law so as to restore complete tax immunity in a demonstration or pilot project whose size is limited to make it cost-feasible but with unlimited benefits to facilitate chances of success.

I have submitted proposed bill language for this tax reform idea. It would authorize a pilot project to establish up to 50 tax-free tribal empowerment zones of limited acreage. These zones would be like tax-free economic oases in a desert, importing and recycling private sector money into Indian country where it has rarely, if ever, been invested for generations.

Such a policy could induce a manufacturing company to locate in Indian country in Montana rather than going to India. It could also motivate a grocery store chain to build their next store in Indian country.

Half of the tax-free tribal empowerment zones would be reserved for applicant Indian tribes with an unemployment rate exceeding 50 percent under the latest Bureau of Indian Affairs workforce re-

ports. The remaining half of the zones would be awarded to applicant Indian tribes that competitively demonstrate the strongest available tribal institutions, fostering effective and stable self-government, predictable legal infrastructure, and tribal policies facilitating entrepreneurial economic development in a business-friendly climate.

Each tribal empowerment zone would be a tax-free territory, immune from all Federal, State, and local income, sales, and excise taxes, and would have an immediate impact on investment and job creation in Indian country.

Mr. Chairman and Senators, to put it simply, current Federal tax incentive policies for Indian country have not worked. Persistent poverty and harsh unemployment still enslave Indian country and deprive too many Indian people of a fair chance at living a full and complete life. The social problems our people face are most often rooted in intergenerational poverty. We are tired of our territories being drained of their wealth for the benefit of others. Please help us restore the flow of wealth back into our nations.

My hope is that you will keep your tax reform efforts simple and consistent with tribal territorial sovereignty. I would recommend for your consideration the creation of tax-free tribal empowerment zones in Indian country so that the private sector will be induced to re-enter Indian country in partnership with sovereign tribal governments and Indian entrepreneurs to let the marketplace create jobs and provide goods and services in Indian country.

This model has worked with Indian gaming, where Federal law acknowledged tribal territorial sovereignty to protect Indian gaming markets and to allow billions of dollars to flow into Indian country, like islands in the middle of non-Indian gaming markets. Likewise, tax reform can create islands of tax-free tribal empowerment zones that attract private sector investment into Indian country markets.

I want to thank you for this opportunity to be here, and I certainly would be glad to take any questions, if you have them.

The CHAIRMAN. Thank you very much. That was very interesting.

Next is Dr. Robertson.

**STATEMENT OF DR. LINDSAY G. ROBERTSON, PROFESSOR OF LAW, UNIVERSITY OF OKLAHOMA COLLEGE OF LAW, NORMAN, OK**

Dr. ROBERTSON. Good morning, Chairman Baucus, Ranking Member Hatch, and other distinguished members of the committee. My name is Lindsay Robertson. I am the Judge Haskell A. Holloman professor of law and faculty director of the Center for the Study of American Indian Law and Politics at the University of Oklahoma College of Law.

I have been a professor of Federal Indian law for more than 20 years. From 2000 to 2010, I served as Special Counsel on Indian Affairs for Oklahoma Governors Frank Keating and Brad Henry. It is an honor to have been invited to address this committee on this important topic.

First, I would like to place the issue of tax policy and tribal economic life in historical perspective, then address potential reforms.

While there are a number of areas in the Internal Revenue Code that could be improved to better serve tribes—input on which others, including President Porter and various organizations, are providing the committee—I would like to highlight two: the essential governmental function limitation on tribal tax-exempt bonding and current limitations on the application of the general welfare exclusion.

Tribal governments in the United States are both pre-constitutional and extra-constitutional. That is, they existed before European settlement and they operate apart from, and not directly subject to, the Constitution.

The U.S. Supreme Court has characterized tribes as "domestic dependent nations"—nations, and not simply aggregations of individuals sharing a particular heritage, but domestic nations, not foreign nations, and therefore having a special relationship to the United States.

In the same decision, *Cherokee Nation v. Georgia*, the court described that relationship as being like that of a ward to his guardian. In 1886 in *Kagama v. United States*, the court recognized the substantive legal consequence to this relationship. As guardian or trustee, the United States has power to legislate over Indian affairs, but also the responsibility to exercise that power to the ultimate benefit of the tribes.

In furtherance of its trust responsibility, since *Kagama* the United States, at numerous stages, has acted proactively to address what it perceived to be problems in tribal economic development. These efforts have been bipartisan.

For example, in the Indian Reorganization Act of 1934, President Franklin Roosevelt's key tribal legislation, the Congress established tribal economic development funds, authorized the creation of tribal corporations, and provided tribes the means to reestablish jurisdiction over lands lost during the allotment era of the late 19th century, when collectively owned tribal lands were divided up and sold.

The Self-Determination and Education Assistance Act of 1975, a Republican initiative, entrusted tribal governments with control over Federal programs operating within their communities, in part on the theory that only in that way would these programs be truly accountable to the people they served.

Whether to comply with a trusteeship obligation grounded in law or morality, or because it simply makes economic sense, Congress has frequently employed its power to legislate tax policy to facilitate tribal economic development.

Now I would like to say a few words in support of the two specific reforms I mentioned when I began my remarks. The first is the elimination of the essential governmental function limitation on tribal tax-exempt bonds found in 26 U.S.C. section 7871.

Tribes are now, and have always been, handicapped under Federal law when it comes to the raising of capital for economic development activities. Since the Trade and Intercourse Act of 1790, tribal land sales without Federal authorization have been invalid under Federal law. While this restriction undoubtedly led to the retention of tribal lands that might otherwise have been lost, it had

the unintended effect of making tribal lands unavailable as security for conventional loans.

Free alienability of such lands is not the solution as long as tribal jurisdiction is closely tied to land tenure. Instead, the solution must involve the creation of compensatory capital generation devices.

Authorizing tribes to issue tax-exempt bonds was a step in the right direction. However, the essential governmental function limitation imposed on the use of funds raised through such bonding limited its utility as an engine for economic development.

It is worth noting that the essential governmental function limitation is not applied to limit the use of funds raised through tax-exempt bonding by States and municipalities, as Commissioner Ingram pointed out. The elimination of the limitation on tax-exempt bonding by tribes would free tribes to raise capital otherwise unavailable to them and make it possible for them responsibly to create their own solutions in today's difficult economic times.

A second important tax reform involves the general welfare exclusion, which is currently interpreted to apply only to tribal means-tested programs. Tribal governments commonly provide benefits to their members, including health, education, and other services. Some of these, including for example language education, are considered essential for the preservation of tribal culture. When the United States taxes these benefits, tribes are handicapped in the services they can provide. Presently, it appears that, not only are these services being taxed, they are being audited at a disproportionate rate. It is difficult to imagine that the revenue generated by taxation of these services outweighs the harm done to tribal governmental operations and cultural preservation.

Moreover, where services are provided to make up for deficiencies resulting from adverse conditions not of the tribes' making, historical conditions, or indeed to further Federal policy objectives, taxing and auditing them appears to me inconsistent with the requirements of the Federal trust responsibility.

I thank you for holding this hearing and for allowing me the opportunity to appear. I would be happy to answer any questions.

Thank you.

The CHAIRMAN. Thank you, Dr. Robertson.

[The prepared statement of Dr. Robertson appears in the appendix.]

The CHAIRMAN. You are last, Dr. Maguire, so you are the clean-up guy here.

**STATEMENT OF DR. STEVEN MAGUIRE, SPECIALIST IN PUBLIC FINANCE, CONGRESSIONAL RESEARCH SERVICE, WASHINGTON, DC**

Dr. MAGUIRE. Chairman Baucus, Ranking Member Hatch, and members of the committee, on behalf of the Congressional Research Service, I thank you for the opportunity to appear before you today.

I have been invited here today to discuss how tax reform could affect the territories. In this oral testimony I will briefly summarize the U.S. tax treatment of the territories and discuss a selected number of expiring provisions, commonly referred to as tax extend-

ers, pertinent to the territories. Finally, I will outline how tax reform may affect the territories.

Generally, Federal tax reform will have an impact on the territories in two ways. First, several territories use the United States' tax code as it is written, replacing the words "United States" with the territory name. As a result, when the U.S. tax code changes, so does their tax code. Puerto Rico is the exception.

Second, there are specific provisions in the U.S. tax code that directly benefit one or more of the territories. This group of provisions is often found in the so-called extenders legislation. I will discuss two extenders here.

First, territories and taxation. The U.S. taxes residents and corporations located in the territories differently than if they resided in the United States. For individuals residing in the territories, their tax treatment is most similar to the tax treatment of foreign citizens. Generally, territorial residents are exempt from Federal taxes on territory-sourced income, but are, with some exceptions, taxed on income sourced in the U.S.

In contrast, U.S. residents are subject to Federal taxes on their territory-sourced income as if it were foreign-source income. However, territorial taxes can be generally claimed as foreign tax credits to offset U.S. tax liability. Thus, as with foreign-source income, the United States concedes primary tax jurisdiction to the territory where the income is earned. With some exceptions, it retains primary tax jurisdiction of the U.S.-sourced income earned by territorial residents.

Corporations chartered in the territories are treated like foreign chartered corporations under the Internal Revenue Code. In principle, they are exempt from Federal taxes on territorial income. U.S. firms that operate in the territories through subsidiaries can, at least potentially, defer Federal taxes on territory earnings. Generally, U.S. taxes are paid only when earnings are repatriated to the domestic parent, with the U.S. tax reduced by any foreign tax credits.

The impact of U.S. tax reform on the territories would depend in large part on the specifics of U.S. tax reform and how the territories responded to the changes. One option would be for these territories to de-couple from the mirror system. This option would allow the territories to be largely unaffected by U.S. tax reform unless they choose to enact similar reforms; administrative complexity and compliance costs would likely rise with the de-coupling, however.

Alternatively, continuing with a mirror system, the territories would incorporate the Federal changes. If the Federal changes focus on increasing progressivity of the tax code, such as higher rates for higher-income earners, the impact on territories would likely be muted, as average income is significantly lower in the territories. In any case, this option would effectively cede control of the territory's tax system to the U.S.

Now I will discuss provisions in the U.S. tax code benefitting the territories. The U.S. tax code includes at least three provisions that directly benefit taxpayers who have income from activities in the territories or who are resident in the territories. If tax reform were to include scaling back tax expenditures generally, one or all of

these may be curtailed or eliminated. Modifications or limitations to broader tax expenditures, such as tax-exempt interest on bonds issued by the territories, are not addressed in this testimony.

Number one is the deduction allowable with respect to the income attributable to domestic production activities in Puerto Rico. U.S.-based entities, either individuals or corporations, are allowed to deduct 9 percent of taxable income that was earned in Puerto Rico.

The deduction lowers the marginal effective tax rates of taxpayers, and the highest bracket amounts to just under 32 percent. This confers a tax advantage for these entities because like-situated entities without Puerto Rican or U.S.-sourced income cannot claim the same deduction unless they are taxed at a higher marginal rate.

This provision expired on December 31, 2011. The President's 2013 budget proposes extending this provision through 2013. The expected revenue impact would be a reduction in Federal revenues of $312 million over the 3-year window of fiscal year 2012 through 2014.

If Congress chooses to broaden the base of both the individual and corporate income tax, they may choose to eliminate the special provision for entities with Puerto Rico-sourced income. The result may be some shifting of activity away from Puerto Rico, though the magnitude of this shift would seem minimal, especially in the short term, as much of the activity generating the income may not be easily or quickly shifted out of Puerto Rico. If Congress chooses additional structural reforms, such as lower overall rates, the value of the deduction to taxpayers would decline.

Number two is a temporary increase on the limit of cover-over of rum excise tax revenue from $10.50 to $13.25 per proof gallon to Puerto Rico and the U.S. Virgin Islands. The United States levies a $13.50 per proof gallon excise tax on distilled spirits produced in, or imported into, the United States. Through 2011, $13.25 per proof gallon of all imported rum is transferred, or covered over, to the treasuries of Puerto Rico and the U.S. Virgin Islands.

The Caribbean Basin Economic Recovery Act of 1983 provides that all revenue from Federal excise tax on rum imported to the United States from any source, including any foreign country, is remitted to the treasuries of Puerto Rico and the U.S. Virgin Islands. In fiscal year 2011, Puerto Rico received over $449 million in revenue, and the U.S. Virgin Islands received $155 million.

The law does not impose any restrictions on how Puerto Rico and the U.S. Virgin Islands can use the transferred revenue. Both territories use some portion of the revenue to promote and assist the rum industry. Reports of the size of the subsidy vary considerably, though the amount ranges from roughly 6 percent of the covered-over revenue in Puerto Rico up to 18.5 percent in the U.S. Virgin Islands as of 2009. Since then, however, the subsidy has increased significantly.

Beginning on January 1, 2012, the amount covered over to Puerto Rico and the U.S. Virgin Islands reverted to $10.50 per proof gallon. The fiscal year 2013 budget proposes extending the $13.25 rate retroactively through 2013. The expected revenue impact of ex-

tending the higher rate will be a reduction in the Federal revenues of $222 million over a 3-year budget window of 2012 to 2014.

I see that my time is up. In the interest of time, I will end here and open it up for questions.

The CHAIRMAN. All right. Thank you, Dr. Maguire, very much.

[The prepared statement of Dr. Maguire appears in the appendix.]

The CHAIRMAN. I would like to ask all of you, all four of you, do you basically agree that the limitation on bonds issued by tribes—that is, the essential government functions limitation—should be repealed? Right down the line.

Ms. INGRAM. Yes.

President PORTER. Yes.

Dr. ROBERTSON. Yes.

Dr. MAGUIRE. Yes.

The CHAIRMAN. All right. So we have agreement there.

Next, with respect to the welfare limitation on taxable income, I would appreciate it if you, Dr. Robertson, and anyone else, would indicate, how should that be modified, if at all? I mean, the argument is that there are some benefits conferred by tribes on their members. Really, some of that should not be taxable income. So where is the line? What is the test? Would there be any limitation? Your views?

Dr. ROBERTSON. Well, I guess I would defer to a variety of organizations, including tribal governments, who have already been in communication with the Internal Revenue Service on this issue. But I can tell you, some of the proposals I am aware of include expanding the definition in the tribal context to eliminate the needs-based component of the analysis, maybe keep the other two elements of the analysis, but make the exemption from taxability no longer related to the income situation of the individual beneficiary, and maybe then loosen up the range of benefits provided that could qualify as welfare.

Tribes do a lot of things that State governments do not do. I mentioned language education. Some tribes, to overcome traditions of poverty and for cultural reasons, provide clothing allowances to families to send their kids to school. Some of those families may be in poverty, some of them may not be in poverty, but this is something that is done across the board. To have some of those recipients singled out for taxation on the value of the benefit frustrates the tribes.

The CHAIRMAN. All right. Either President Porter or Ms. Ingram, your thoughts?

President PORTER. Mr. Chairman, I have a hard time seeing why any of the benefits that we are providing to our people should fall under any taxation because the services that we provide for our people are to help them. We have the worst health care, we have the worst degree of social problems in our Nations.

The sources of income that we derive from our businesses, from our grants that we use to provide services, are going directly back to our people. We are not starting from some exalted position of health care or socioeconomic status where these are luxuries, where these are things that are perceived to be things that most humans do not have. We are trying to get back to a position of nor-

mal after recovering from many, many generations of deprivation. So I would say that there should not be——

The CHAIRMAN. Do tribes provide unemployment benefits?

President PORTER. We do not. We actually work in concert with the State system for purposes of unemployment insurance.

The CHAIRMAN. All right. Sure.

President PORTER. But we do not.

The CHAIRMAN. Ms. Ingram? The general proposition of welfare limitation.

Ms. INGRAM. I think we are in a position of trying to figure out how to administer something that is a creature of administrative rulings. It started in the environment of State and local governments, and over the years has been increasingly raising issues with Indian tribal government programs.

I think our effort to step back for a moment, and through that notice and through a specific and formal consultation process, will allow us to hear a couple of things from the tribal community. One is, as has been mentioned, the kinds of programs that are either like those provided to the States or are unique in the tribal context and should be taken into account. We are listening very carefully to the input on that category of questions.

Also, the question of the extent to which the taxation of the recipient should be based on their needs, is something that has been around for a long time in this string of administrative rulings, and is something we are hearing is of great concern. We have given favorable treatment or unfavorable treatment to lots and lots of governments, tribal and non-tribal, based on those standards, and I think it is perfectly reasonable for us to listen to the tribal community.

The CHAIRMAN. But do you have a recommendation how to simplify this so the tribes do not have to jump through all these hoops?

Ms. INGRAM. Well, I think we are on a journey with the tribal community to see if we can figure that out. This being an administrative doctrine and being very fact-specific in its nature, I think we would welcome, as much as the tribes would, trying to find a simpler way to approach this.

The CHAIRMAN. All right. Thank you. My time is up. Thank you.

Senator Hatch?

Senator HATCH. Well, thank you, Mr. Chairman.

President Porter, in your written testimony you are critical of many of the tax provisions that have been enacted in the past in order to aid Indian country. In their place, as I view it, you suggest the creation of a series of tax-free tribal empowerment zones. Now, from my reading of your idea, these areas would be exempt from all U.S. Federal and State taxes that might otherwise apply for a period of 10 years, as I understand it.

Now, please describe how this process is fundamentally different from the renewal community and empowerment zone provisions that you criticize, and why do you think it would be more successful? How did you come to select 10 years as an appropriate lifetime for the proposal?

President PORTER. Well, the proposal is rooted in the idea, Mr. Vice Chairman, that the existing provisions of law simply are too incremental. They are never permanent. They never allow for any

real foundation for growth and development. As a result, they do not work.

Trying to attract companies to your territory, which I have tried to do, they look at these tax incentives, they look at the tax opportunities, and they say, well, who knows what is going to happen in a year or two, because it is not permanent. Congress has a pattern of delaying the extension. So from a business perspective, it is just not a very credible invite to be able to attract capital into our territory.

Ten years might be a minimum. The idea that a company is going to work in our territories, in a zone in which there are no taxes, is patently attractive on its face. But then you get into the second-level questions, which are still a challenge: what is the legal infrastructure of the tribe? What is your access to markets if we are making a product? What is the demand for the services, if we are providing a service? There are still going to be other hurdles to overcome as it relates to this kind of development incentive.

But I think, when it relates to creating an attractive magnet by which we can draw capital and investment—in my nation we have succeeded significantly, in the gaming context, to invite Wall Street money into our nation for investment for gaming facilities. I am a strong believer that we can do the same thing outside of gaming and help diversify our economies and become less dependent on that particular business, if we can have this kind of assistance from the Congress.

Senator HATCH. Thank you.

Dr. Maguire, let me ask you a question. As your testimony has made clear, there are areas where the territories could be treated in a more uniform fashion. For example, some have mirror codes and some have non-mirror codes; in some ways they are treated like foreign countries, in other ways, like States.

Now, do you think greater uniformity is necessary or feasible or desirable? More specifically, does it make sense that the R&D performed in a territory qualifies for the R&D credit as if the territory were a U.S. State, while at the same time income taxes paid to a territory may be claimed as a foreign tax credit, as if the territory were really a foreign country?

Dr. MAGUIRE. Well, I think greater conformity across the territories would decrease compliance costs and increase administrative simplicity. On the other side of the coin, Congress has decided to confer certain tax advantages to the territories, recognizing their position economically.

So it is true that the research and development tax credit would seem to be a "double dipping" for the territories if there is also a foreign tax credit available. So, when balancing greater uniformity with providing tax benefits to the territories as a general welfare, I think that is a question that Congress will have to answer, and unfortunately I do not have a good answer for you.

Senator HATCH. Does it make sense that the section 199 domestic manufacturing deduction may be claimed for activities in Puerto Rico but not in other territories?

Dr. MAGUIRE. That does not make sense to me, though those who crafted the legislation, I am sure, had legitimate reasons for structuring the section 199 the way it is structured.

Senator HATCH. My time is about up.

The CHAIRMAN. Thank you very much, Senator.

Senator Menendez is not here, so we will move to Senator Bingaman.

Senator BINGAMAN. Thank you very much.

Let me ask Ms. Ingram, you indicate that the IRS plans to publish written guidance to address, particularly, this issue of the general welfare exclusion.

Ms. INGRAM. Yes.

Senator BINGAMAN. Is there any consideration, or does it make any sense to consider the wealth of a tribe in those guidelines that you issue? I mean, my sense is that many tribes are as President Porter has described, and they have great needs and substantial poverty and all.

But we have some exceptions. We have some tribes in this country that are doing quite well, primarily because of gaming, but in some cases other factors. Is there any consideration of distinguishing in that regard, or would it make sense to even think about that?

Ms. INGRAM. Senator, we are not going along those lines at all. That is not a criterion that we have ever used with State and local government programs, and we have not to date, and do not have any plans to take it into account in the Indian tribal community.

Senator BINGAMAN. All right.

Let me perhaps ask Dr. Maguire about his testimony. He talks about one option if we go ahead here with major tax reform. He says one option would be for these territories to decouple from the mirror system that has been in place. That would seem to me to be a bad idea. I mean, it would seem to me that, to the extent you decouple, you add great complexity to the issue.

You have each of the territories essentially developing its own tax provisions, which of course would then require not only that you hire a raft of lawyers and accountants, as you have to today, but you would have to hire a very specific group of lawyers and accountants who would presumably have the expertise to tell you what the tax system was in each of these territories. What is your thinking on this?

Dr. MAGUIRE. I tend to agree with you that, from an administrative simplicity and compliance cost, that would be a move in the wrong direction. That said, within the territories, overlaying the U.S. tax code onto the territories also overlays the policy decisions of the U.S. Congress on the territories. So, the actions that Congress takes will have a direct impact on the territories. So again, there is that rub between administrative simplicity and complexity and what you do to promote the economic efficiency within the island or within the territory, if that makes sense.

Senator BINGAMAN. I think Senator Hatch was getting at this in some of his questions. But I guess one obvious sort of threshold issue is, should we have a guiding principle with regard to these territories, which essentially determines that they be treated as States, except where we decide that there is an exception to that? Is that kind of a guiding principle in place today? Would it make sense for us to consider that and have that as a guiding principle, in your view?

Dr. MAGUIRE. I think that is one of the options that was explored by the Joint Committee on Taxation in their pamphlet, that they prepared for the hearing today.* In that pamphlet, they recognized the difficulty in treating them as States because they are very different than the States, economically and demographically. So from that perspective, I do not think it would be a good default position.

A good default position may be that they all use the mirror system, they all use the Federal tax code, and then as Congress sees fit—makes adjustments for territories as needed rather than having a mix of dual-filing entities versus single-filing entities within the territories—using a consistent treatment to begin with and then making modifications.

Senator BINGAMAN. My time is up, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Senator Cantwell? Oh. I will go to Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Dr. Maguire, thank you for your testimony. Above all, I appreciate your expertise on so many issues: AMT, bond financing, the rum cover-over program. It has been incredibly beneficial to have your expertise. That is really where I want to focus my questioning, is on the rum cover-over program.

I find it ironic that Diageo's rum brand is named after a pirate, because they set a precedent of pillaging a program that is meant to provide budgetary support to the territories. In my view, the deal Diageo struck with the U.S. Virgin Islands devastates the effectiveness of the cover-over program for the people of the territories by gutting the revenue that is supposed to go to vital public services and sets a precedent that is pretty terrible, and a race—I think a death spiral—to the bottom.

So this is a real concern to me, and I would like to have you help us shed some light on some of these points. What is the total value of subsidies provided to Diageo by the U.S. Virgin Islands, which include, as I understand it, paying for a new distillery then giving the ownership of the distillery to the company, paying for much of the cost of the main ingredient, molasses, and paying for a substantial portion of marketing costs?

Dr. MAGUIRE. In 2009, I went through and calculated it on my own instead of relying on outside reports of what the subsidy was, and I arrived at 18.5 percent. Of course, since the Diageo plant was constructed and the agreement implemented, that subsidy has increased significantly. I have seen internal documents between the government of the Virgin Islands and Diageo that the subsidy is closer to 46 percent today.

Senator MENENDEZ. So it is 46 percent of cover-over revenues just to one company.

How many people are employed by the distillery that produces Captain Morgan's r um?

Dr. MAGUIRE. In the agreement, Diageo indicated they would hire anywhere from 40 to 70 people in the facility itself, but that

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* For more information, *see also,* "Overview of Federal Tax Provisions and Analysis of Selected Issues Relating to Native American Tribes and Their Members," Joint Committee on Taxation staff report, May 14, 2012 (JCX–40–12), *https://www.jct.gov/publications.html?func=startdown&id=4426*, and "Federal Tax Law and Issues Related to the United States Territories," Joint Committee on Taxation staff report, May 14, 2012 (JCX–41–12), *https://www.jct.gov/publications.html?func=startdown&id=4427*.

does not take into account any ancillary jobs that would be created from the activity at the plant.

Senator MENENDEZ. And of these jobs, how many would you say were a net increase in the territories versus simply a transfer of jobs between two territories?

Dr. MAGUIRE. That is a good question. To the extent that there is mobility between Puerto Rico and the U.S. Virgin Islands, I am not certain of that. There is probably a mix of replacing and new employment, but on net it is probably a relatively small percentage of those new jobs.

Senator MENENDEZ. Well, we believe that we are close to zero, since the loss of production in Puerto Rico led to a commensurate loss of jobs there.

So, looking at how these numbers intersect, how much would you estimate is going to Diageo per job transferred from Puerto Rico to the U.S. Virgin Islands?

Dr. MAGUIRE. Well, in fiscal year 2011, the U.S. Virgin Islands received $155 million in covered-over revenues, so half that, or 46 percent, would probably be $70 million or so in fiscal year 2011. But, as production ramps up moving forward, the cover-over value would increase, production will increase, and the subsidies will also increase, so that number will get larger.

Senator MENENDEZ. So I look at those numbers, and I look at the number of jobs, the 40 to 70 direct jobs, and maybe an indirect employment of approximately 230 jobs. Basically, the U.S. Virgin Islands will pay Diageo between $1.2 and $2.2 million per direct job per year created, and approximately $391,000 when indirect jobs are estimated. So that is pretty outrageous. That is pretty outrageous, and it is unsustainable.

Can you briefly talk about what has happened to the subsidies for the other producers in Puerto Rico and the U.S. Virgin Islands since the Diageo contract became public?

Dr. MAGUIRE. I have seen news reports that indicate the government of Puerto Rico has loosened their self-imposed restriction on the subsidies that they can provide to rum producers in their territory. It seems that other rum producers not named Diageo have also requested additional subsidies in light of the Diageo agreement, and those are news reports that I have not verified myself, but they seem reasonable.

Senator MENENDEZ. Well, I can tell you that the government of Puerto Rico, based upon what happened with the Virgin Islands, then increased its assistance to rum producers from 6 to 10, and now 25 percent, so much so that CARICOM, the Caribbean nations, have told the executive branch that the subsidies are unfair trade practices and violate international trade rules.

Let me close by saying, is it fair to say that, based upon all this information, that money is flowing to profits, not jobs, here at the end of the day?

Dr. MAGUIRE. To the extent that we understand how the subsidy is used by Diageo, it does appear as though it does not go to the workers at the plants, and it does not go to lower rum prices, necessarily. Most of it would go towards the investors in the rum companies.

Senator MENENDEZ. Mr. Chairman, so this is the challenge we have if we allow this to continue to happen. Instead of supporting—which was the intention of the rum carry-over provision—the people of the territories to help improve the standard and quality of their lives, what we are doing is having millions of dollars go for profits for companies that are not really producing the benefit for these territories.

So I hope we can work with the chairman and the committee to try to find the right balance here so that, at the end of the day, we can pursue the original intention. Because otherwise I could see very easily that there will be a tax on this program, to the extent that they will seek to take it away, and it will be far worse for the territories at the end of the day.

The CHAIRMAN. Thank you, Senator.

Senator Cantwell?

Senator CANTWELL. Thank you, Mr. Chairman. Thank you for holding this hearing.

One of the issues—we have many tribes in the Northwest, and my colleague from New Mexico asked about—well, many of my colleagues asked about the general welfare doctrine. But I am particularly interested in the area of education, because Native Americans have a lower high school graduation rate. In fact, I think it is something like 23.5 percent who do not complete high school or the equivalency of high school. So juxtapose that to, say, 4.7 percent of whites, or 14 percent of Asians, and a whole host of other segmentations.

So, when it comes to this issue of taxation and what is a general welfare or social benefit program, you can have something like tuition—and I certainly applaud Native American tribes across America for supporting continued education for their members. I think this is a very, very positive sign. But my understanding is, we have a lot of mixed signals here, so that you can have tuition that is covered under this social benefit or general welfare idea, but then books or room and board are not. So, why is there a difference, and what do you think we need to do to clarify this? So, either Professor Robertson or President Porter.

President PORTER. Senator, I think that you have hit the nail on the head when it comes to the challenge of administering in this area. That is why I do not think there should ever be a tax question when it comes to providing backpacks or pencils to children in our nation, or any Indian nation in the United States. We are, in many cases, not continuing education, we are starting it.

In our case, our language is almost gone, and we are trying to re-install a language immersion school. We are trying to raise our children in a way of life that Americans take for granted. But it is the universal solution to our problems when we can provide a strong education, and we have a multitude of issues with the potential tax threat.

Even on the financing side, building schools, finding ways in which we can provide for that, we need to make sure that those opportunities are protected so that we can move forward with our investments.

Senator CANTWELL. Doctor?

Dr. ROBERTSON. I agree with President Porter. I would just sort of amplify that I think the benefit of the exclusion applies to a multitude of levels of education. It is not simply elementary education or secondary, but a lot of tribes are providing monies to send their members away to study medicine, to study law, to study business, to study engineering, so that they can come back and help rebuild the tribe's health base, infrastructure, political institutions, that sort of thing. All of this is seen as being for the good of the community within those communities more than for the good of the individual, who then otherwise would be taxed on the receipt of a benefit.

Senator CANTWELL. And so I would just assume that, aside just from compliance, that the complexity of knowing what is and what is not excluded is pretty hard to figure out. Is that correct?

Dr. ROBERTSON. Yes it is, under the status quo. And I do not think the Service disagrees with that, as I understand from Commissioner Ingram's testimony, which is why they are working with tribes—and I think this is creditable—to try to figure out a way to simplify these rules, if not eliminate them, which is President Porter's suggestion, which would simplify things.

Senator CANTWELL. Ms. Ingram, is there a simplification on this?

Ms. INGRAM. Well, as I mentioned before with Chairman Baucus, we are very cognizant of this issue, which is why we have reached out for input, and one of the categories we have asked specifically for input on is in the area of education, as well as the area of cultural practices, events, and issues. We have tried over the years to figure out how to take the principles that were largely crafted in the State and local government environment and translate those to the more complex situation involving the Indian tribal community.

We have asked for, and continue to receive, a rich amount of input about what kinds of activities people are doing and want to do, and how these are either the same as what we currently allow for States—and we need to be consistent with that—or to what extent it needs to be different. We are trying to listen to that input to figure out what to do next.

Senator CANTWELL. Do you think there is a difference between tuition and room and board?

Ms. INGRAM. I think there is both some information and misinformation about where we are in agreement or disagreement. One of the things we are doing, in addition to the consultation sessions, is tightening some of our coordination within our own organization to see if we cannot eliminate some of the fact patterns where we know already, without further discussion, that we should not be questioning. I think this discussion will create areas—we hope—where we can provide some broader, simpler ways for both of us to address this and all the other issues that are being raised.

Senator CANTWELL. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Thank you all very much. This has been a very helpful hearing, with very good points to very difficult questions. My thought is just to move towards simplicity, and clearly repealing the essential government function provision will help make things a little more simple.

But I also urge you to give us your ideas. I mentioned the welfare provision. I did not get a chance to ask you, President Porter, I know some of the tribes do very well with gaming. Your economic opportunity zone looks very interesting, but I presume that would not apply to gaming reservations. I say that in part because we in Montana do not have the people for gaming.

President PORTER. Right.

The CHAIRMAN. It just does not work. Different tribes are different in different parts of the country. Just idle comments, unless you have something to say.

Thank you all very, very much. I appreciate it.

The hearing is adjourned.

[Whereupon, at 11:08 a.m., the hearing was concluded.]

# APPENDIX

## Additional Material Submitted for the Record

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**Hearing Statement of Senator Max Baucus (D-Mont.)**
**Regarding What Tax Reform Could Mean for Tribes and Territories**
*As prepared for delivery*

There is a Crow proverb that says, "Man's law changes with his understanding of man. Only the laws of the spirit remain always the same."

Our desire to spur broad-based economic growth and give help to those who need it stays the same. But our laws are ever-changing. And while some were well-intentioned, the 15,000 changes made to the tax code since 1986 have created too much complexity and unfairness. Tax reform needs to simplify the code in a way that creates jobs and encourages growth.

Today, we look at tax reform and how it affects Indian tribes and the United States' five territories: Puerto Rico; the U.S. Virgin Islands; Guam; American Samoa, and the Northern Mariana Islands.

Indian governments and the territories are in some ways similar to state governments; each provides hospitals, public schools and law enforcement. But U.S. policies do not recognize tribal governments or territories as states or fully-sovereign nations.

Instead, U.S. law is a patchwork of complicated rules for each territory. And for tribal governments, U.S. policies are inconsistent. Tax policy is a microcosm of this inconsistency.

The unemployment rate on some reservations, such as the Northern Cheyenne reservation in Montana and the Pine Ridge reservation in South Dakota, is 80 percent.

One in four Indians lives below the poverty line. American Indians' median income is 31 percent less than all other Americans. U.S. territories and commonwealths also suffer from high unemployment.

In the past, Congress has recognized the special status of tribal governments and the island territories and taken steps through our tax policies to improve their economic conditions.

We provided accelerated depreciation for capital investments and an employment credit for businesses located in Indian country. Congress also allowed businesses to claim a credit for the production of coal from Indian land.

The accelerated depreciation provision brought jobs and economic activity to the Crow Tribe in Montana when Westmoreland Coal used it to boost profits.

But there are issues with these provisions. Two-thirds of the state of Oklahoma qualifies as an eligible Indian reservation under the accelerated depreciation provision and employment tax credit as written. Perhaps the tax laws need to be better targeted.

Congress should also level the playing field for tax-exempt bonds. States are currently allowed to issue tax-exempt bonds for any public purpose. These bonds help governments access cheap capital to build schools and court houses. States can also use them to finance tourism and economic development projects like municipal golf courses, convention centers and hotels.

In contrast, tribal governments can only issue bonds for government buildings. Their bonds have to pass what's called an "essential government test."

To address this inequity, in 2009, Congress authorized two billion dollars of tribal economic development bonds for any purpose other than gambling facilities. The Treasury Department studied the program, and it recommended Congress repeal the essential government test. We should do this as part of tax reform.

Another area of concern for tribal governments is the application of the general welfare doctrine. This doctrine allows governments to provide benefits to citizens without those benefits counting as taxable income.

Tribes provide many benefits to their members including educational assistance and cultural awareness, along with housing and meals. But it's often unclear which benefits are eligible for the exemption. That uncertainty is tough on families and tribal governments, and it's something we should fix.

For U.S. territories, federal tax law previously contained an economic activity tax credit and a possessions tax credit to encourage investment. These credits expired at the end of 2005. Another provision set to expire sends a portion of excise taxes on rum to two territories to help fund their government operations. Today's hearing provides an opportunity to consider these issues in the context of broader tax reform.

I hope today's witnesses will help us understand what roadblocks should be eliminated and what incentives work for Indian Country and the territories.

When I talk with tribes in Montana, they tell me the same thing – they want a better future for their children and less reliance on the federal government. These are goals we all share.

So let us use tax reform as an opportunity to achieve those goals. Let us think outside the box. Let us hear what might be done to help tribes and territories meet their goals.

And in the spirit of the Crow proverb, let us take this opportunity to make man's law reflect our common desires.

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**Statement for the Record**
**United States Senate Committee on Finance**
**Hearing on Tax Reform: What It Could Mean for Tribes and Territories**
**May 15, 2012**

**Statement of Senator Mark Begich**

Chairman Baucus, Ranking Member Hatch and Members of the Committee:

Thank you for the opportunity to submit this written statement for the record in connection with the Committee's Hearing on Tax Reform: What It Could Mean for Tribes and Territories. I am writing to encourage the Committee to address a provision that is scheduled to expire on December 31, 2012 that will greatly impact the economic well-being of the Alaska Native community.

I have introduced, along with Senator Murkowski, S. 1337, which would make permanent Section 646 of the Internal Revenue Code, currently scheduled to expire on December 31, 2012. Companion legislation, H.R. 2320, has been introduced in the U.S. House of Representatives by Representative Young. In August 2011, the Joint Committee on Taxation estimated that the permanent extension of Section 646 would cost $41 million over the 10-year budget window. I appreciate the fact that prior to the two-year extension of Section 646 as part of the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010*, Chairman Baucus had proposed a permanent extension of the provision. *See* SA 4727 to H.R. 4853 (2010). Although the permanent extension was not ultimately enacted, I appreciated his demonstration of support.

I would note that making Section 646 permanent is consistent with one of the stated goals of tax reform, which is to address the compliance and administrative burdens associated with temporary provisions currently in the Internal Revenue Code. Furthermore, as a matter of Federal Indian policy, making Section 646 permanent will finally remove the cloud of uncertainty as to whether Alaska Native Settlement Trusts are a viable vehicle to improve the socio-economic condition of Alaska Natives in fulfillment of the ANCSA promise.

Section 646 allows Alaska Native Settlement Trusts to protect, for current and future generations of Alaska Natives, valuable portions of their aboriginal land claims settlements under the Alaska Native Claims Settlement Act ("ANCSA"). The trusts provide valuable economic and social benefits to Alaska Natives, including cash distributions to provide for basic needs, educational scholarships, cash payments to the elderly and funeral benefits. In the absence of these benefits, many Alaska Natives would simply not have the means to provide for themselves and their families.

Section 646 provides an elective regime that allows each Alaska Native Settlement Trust to maximize the benefits it provides to Alaska Natives by providing for a trust-level tax at the lowest individual rate in lieu of any beneficiary-level taxes, allowing contributions to a trust on a tax-efficient basis, and providing streamlined administrative reporting.

Section 646 has a unique procedural history, and it is for this reason alone (and not because of any substantive deficiency in its policy merits nor revenue concerns about its cost) it is not already a permanent part of the Internal Revenue Code. Section 646 was originally enacted, along with several other provisions, as an unrelated, miscellaneous provision as part of the *Economic Growth and Tax Relief Reconciliation Act of 2001* ("EGTRRA") which, because of the need to use the budget reconciliation process, was subject to a December 31, 2010 sunset provision. Rather than subsequently being made permanent, similar to other unrelated, miscellaneous provisions in the 2001 tax legislation, Section 646 was extended for two years as part of the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* such that it is now scheduled to expire on December 31, 2012. Once again, the decision to enact a two-year extension (rather than a permanent extension) was not attributable to substantive or revenue considerations relating to Section 646 itself. Rather, it followed from a decision to enact a simple two-year extension of all of the expiring provisions of EGTRRA without assessing the merits of alternative extension periods for each expiring provision being extended. Thus, it is fair to say that the current non-permanent status of Section 646 is an accident of the legislative process. Therefore, I respectfully request that the Committee remedy this accident of the legislative process and make permanent a provision that should have originally been passed. In the event that Section 646 is not made permanent, I respectfully request that the provision first be extended for as long as possible on such a vehicle and then subsequently be made permanent as part of any longer-term fundamental tax reform effort.

Thank you again for the opportunity to submit this written statement for the record. I look forward to working with the Committee to ensure that Section 646 is made permanent as soon as possible to ensure that the important benefits that Alaska Native Settlement Trusts provide to the Alaska Native community are continued.

Respectfully submitted,

Senator Mark Begich

## STATEMENT OF HON. ORRIN G. HATCH, RANKING MEMBER U.S. SENATE COMMITTEE ON FINANCE HEARING OF MAY 15, 2012 TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES

WASHINGTON – U.S. Senator Orrin Hatch (R-Utah), Ranking Member of the Senate Finance Committee, today delivered the following opening statement at a committee hearing examining the impact of tax reform on tribes and territories:

Thank you Mr. Chairman. This hearing deals with two very important yet distinct topics — tribal tax issues and territory tax issues. I want to stress that I do not come into this hearing with any preconceived agenda of how we ought to treat tribes and territories. Rather, we must consider how we can be most productive on these matters when we undertake fundamental tax reform.

With respect to tribal tax issues, certain of them, such as the general welfare exclusion, seem to have been outstanding for several years, and this Committee needs to determine the scope of actions to be taken when fundamental tax reform is finally realized.

Aside from the long-term implications for tax reform, there are short-term questions concerning the subject matter of today's hearing. Several so-called tax extenders explicitly designed to aid Native American tribes, such as accelerated depreciation for business property on Indian reservations, have actually expired. The credit for the production of Indian coal will expire at the end of this year. If we are going to break out of the repetitive loop of short-term extensions, we should not put off a discussion of these temporary measures, even prior to comprehensive tax reform.

I am also interested to hear about the tax treatment of territories. In a nutshell, even though the people of the various possessions are United States citizens or nationals, most do not pay tax to the federal government, but rather to their possession's government.

Some U.S. possessions have a mirror tax code, with tax laws essentially identical to the U.S. Internal Revenue Code, simply swapping the name of the possession wherever the Internal Revenue Code says *United States*. Yet others are given more autonomy to write their own tax laws as they see fit.

In some ways, possessions are treated like foreign countries. In other ways, however, they are treated like states. For example, research and development in a territory is eligible for the R&D credit, just as if the R&D were performed in a U.S. state. However, income taxes paid to a possession's government are generally eligible for a U.S. foreign tax credit, just as if paid to a foreign government. Of course, taxes paid to a state government are not creditable, and only sometimes deductible.

I will be interested in understanding whether greater consistency in the tax treatment of possessions is desirable or feasible.

I share the Chairman's dedication to thoroughness that this committee's tax reform hearings represent, and the emphasis they place on technical knowledge. I expect that this hearing will make a worthy contribution to that effort.

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**Testimony of Sarah H. Ingram, Commissioner, Tax Exempt and Government Entities, Internal Revenue Service**

**Before the Senate Finance Committee**

**Tax Reform: What It Could Mean for Tribes and Territories**

**May 15, 2012**

Introduction

Good morning, Chairman Baucus, Ranking Member Hatch, and members of the Committee.

I appreciate the opportunity to be here this afternoon to discuss how the general welfare exclusion applies to tribal programs and to discuss tribally issued tax-exempt bonds.

At the opening of my testimony, I want to acknowledge that the United States has a unique government-to-government relationship with Indian tribes as set forth in the Constitution of the United States, treaties, statutes, executive orders, and court decisions. The Office of Indian Tribal Governments within the Internal Revenue Service (IRS) was created in response to requests by tribal leaders. This office exists to facilitate the government-to-government relationship and to assist tribes in meeting their Federal tax obligations.

The Principal Issues

We have two principal issues to discuss today: the general welfare exclusion and tribally issued tax-exempt bonds.

**General Welfare Exclusion**

I would like to first review the general welfare exclusion. Tribes, like all governments, sponsor social welfare programs designed to support their members. Of principal relevance to the IRS is whether payments made through those social welfare programs are taxable. To be very clear, whether this exclusion is or is not applied does not limit what benefits or social programs Tribes can provide to their members. The question is whether the provision of those benefits is excludable from general income under the general welfare doctrine.

In order to provide context to this discussion I would like to briefly explain certain tax principles that apply to government social welfare programs, how the IRS has applied these principles in the past to tribal social welfare

programs, and what the IRS is doing in order to address the concerns of the Indian tribal community on this topic.

Brief Explanation of Tax Principles

The two concepts relevant to this discussion are gross income and the Service's administrative general welfare exclusion from gross income.

Section 61 of the Internal Revenue Code (Code) provides that gross income includes all income, from whatever source derived, unless a specific exception in the Code applies. This provision establishes the general rule that income will be taxed unless it is expressly excluded from taxation.

The general welfare exclusion is, however, a non-Code exception. It is an administrative exclusion that has been developed in official IRS guidance and recognized by the courts and Congress over a fifty-five year period. See, e.g., Rev. Rul. 63-136, 1963-2 C.B. 19; 6 *Graff v. Commissioner*, 673 F.2d 784 (5th Cir. 1982), *affg. per curiam* 74 T.C. 743 (1980); *Bailey v. Commissioner*, 88 T.C. 1293 (1987).

Some have expressed a concern that guidance on the general welfare exclusion lacks clarity because it is not found in the Code but in these other forms of administrative guidance and court decisions that stretch over five decades.

It is clear that the exclusion can apply to payments made by governmental units, tribal or non-tribal. Although Code section 61 defines broadly the items that are included in gross income, the IRS has consistently concluded that payments made to individuals by governmental units, under legislatively provided social benefit programs, for the promotion of the general welfare, are not includible in a recipient's gross income. *See, e.g.,* Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 98-19, 1998-1 C.B. 840.

To qualify under the general welfare exclusion, payments must: (1) be made under a governmental program, (2) be for the promotion of general welfare (*i.e.*, be based generally on individual, family or other needs), and (3) not represent compensation for services.

I'd like to emphasize that the general welfare exclusion applies equally to general welfare program payments of all governments, tribal, federal, state, and local.

Past Application of the Exclusion to Tribal Programs

The IRS does not have and never has had a special program for examining tribal government social welfare programs. Historically, there were two

primary ways that the IRS came to analyze tribal social welfare programs and whether payments made through these programs qualified for the general welfare exclusion.

One way that the IRS may come to examine a tribal program is for the tribe to seek a letter ruling from the IRS on the tax implications of a certain program. The IRS has historically provided all governments, tribal and non-tribal, with the opportunity to seek a letter ruling to determine if a certain program qualifies for the general welfare exclusion. Some tribes have availed themselves of this process. However, the expense, time needed, and the limited reliance provided by a letter ruling may have discouraged tribes from seeking letter rulings for their programs.

The second way tribal social programs may come under review is through an examination of a tribal government's tax reporting compliance. The Code requires all persons, including Indian tribal governments, to report certain payments of $600 or more to the IRS. During an examination, a review of an Indian tribal government's books and records may show payments of $600 or more to tribal members for social programs. These payments require further consideration, because payments to which the general welfare exclusion applies do not have to be reported.

The IRS always examines a program using the same three prong analysis of the general welfare exclusion. There has not been significant concern voiced to us regarding the first prong of this analysis: whether payments are being made from a government fund or not. The comments we have received on the application of the general welfare exclusion within the tribal context have been on the second and third prongs of the analysis: whether the payments are being disbursed based upon the needs of the recipient and whether the payments constitute compensation received for services.

For example, in one private letter ruling, a tribe provided certain educational assistance and benefit payments to its members who attended institutions of higher learning and vocational or occupational training. Most tribal members qualifying for assistance had an income below the national family median income level. In this instance, it was determined that the educational assistance payments were made to enhance educational opportunities for students from lower-income families and, therefore, were excluded from gross income because the payments were for the promotion of the general welfare.

In another ruling, it was determined that payments to participants in a tribal program designed to train unemployed and underemployed residents in construction skills were excluded from income under the general welfare exclusion because the primary purpose was training, which is based on the need for additional skills to prepare for the job market, and was not a payment for the compensation of services.

The difficulty in these examples and in applying the general welfare exclusion has been that each application is fact specific and requires an independent analysis. The historical and cultural context within the tribal government context adds a layer of complexity to this analysis. Historically, Tribes have expressed their concern to us that the IRS has not consistently applied the general welfare exclusion.

The IRS Response to Tribal Concerns

At various points, different Tribes and Tribal leaders have voiced concerns over the application of the exclusion provided under the general welfare doctrine. This issue came up through various levels of consultation and outreach with Tribes and Tribal leaders.

In November, 2011, in response to these consultation sessions, various meetings and general outreach with Tribes and Tribal leaders, and internal IRS and Treasury discussions, the IRS issued Notice 2011-94, which invited comments concerning the application of the general welfare exclusion to Indian tribal government programs. The purpose of the Notice was to begin a specific consultation process with Tribes on how to find a solution that addressed their concerns and improved clarity and consistency of the tax law.

The IRS has received over 65 written comments from Tribes and Tribal leaders submitted in response to Notice 2011-94. We are still reviewing those comments as we consider the next step in this process. Additionally, the IRS and Treasury held a general welfare-specific consultation session in conjunction with the White House Tribal Nations Conference on November 30, 2011. It was attended by over one hundred tribal representatives. On March 8, 2012, Treasury and the IRS participated in a consultation session hosted by the National Congress of American Indians in conjunction with their annual conference and attended by approximately forty tribal representatives. IRS and Treasury will host another consultation session through teleconference on May 30, 2012.

The IRS plans to publish written guidance that will address issues raised by tribes in their comments. Our intent is that this published guidance, along with improved internal coordination procedures, will provide increased clarity and consistency of the application of the general welfare doctrine. In the process of doing so, we will respond to many of the concerns which we have heard through the written and in-person consultation sessions. Our goal is to publish guidance as soon as possible. Tribal concerns are very important to us and we look forward to working with tribes on this item in the future.

**Tribally Sponsored Tax-Exempt Bonds**

The second topic of discussion is that of tribally issued tax-exempt bonds. Tribes, like all governments, utilize tax-exempt bond financing as a means of funding economic development. Today, I would like to provide a brief historical background on tribal bonds and address what the IRS is doing to facilitate the rate of tribal bond issuance.

Brief Historical Background of Tribal Bonds

The Indian Tribal Governmental Tax Status Act of 1982 added section 7871 to the Code. Among other things, this provision of the Code grants Indian tribal governments the authority to issue tax-exempt bonds. This provision does have a limiting provision. The limiting provision of section 7871 generally requires that proceeds of tribal tax-exempt bonds be "used in the exercise of an essential governmental function." Further, section 7871 also provides that tribes are not allowed to issue private activity bonds except in limited circumstances to finance certain manufacturing facilities. Since enactment in 1982, we have consistently heard from tribes that these requirements significantly limit the ability of tribes to fund certain projects and that these requirements are unfairly restrictive in comparison to the more flexible standard for tax-exempt bond financing that applies to State and local governments.

The American Recovery and Reinvestment Act of 2009 (ARRA) created a new type of tribal tax-exempt bond authority generally referred to as "tribal economic development bonds" and authorized two billion dollars in bond authority for the new bond program. Tribal economic development bonds are not subject to the essential government function test applied to traditional tax-exempt bonds for tribal governments. This key difference allows tribal governments to fund projects that they would not historically have been authorized to fund with tax-exempt bonds. In 2010, under ARRA, the IRS allocated the authorized tribal economic development bond authority in two tranches. The entire two billion dollar volume cap was allocated. Through the end of 2011, however, less than three percent of the tribal economic development bonds were ultimately issued. The IRS has consulted with tribes and has received constructive feedback on causes of the low issuance rate. Among other reasons, tribes have stated the low issuance rate was due to the allocation period being too short, the new bond characteristics not being readily understood, credit constraints impede access to the market for tribes, and the national economic environment not being conducive to new bond issuances.

The IRS Response to Tribal Concerns

The IRS endeavors to facilitate tribal bond issuance by providing timely and relevant guidance related to tribal bonds. In November, 2011, the IRS formally solicited written comments from tribes on how to improve the allocation process for tribal economic development bonds. Most of the two billion dollars in tribal economic development bond volume cap remains available for re-allocation after administrative expiration of the unused allocations at the end of 2011. The IRS received numerous written comments from tribes and is reviewing the submitted comments in order to determine what adjustments can be made in a revised allocation process in order to facilitate an increase in the issuance rate. After carefully considering the comments received, the IRS expects to issue public guidance in the near future to announce a revised process for reallocating the unused bond volume cap for Tribal Economic Development Bonds.

I am aware of the Administration's commitment to strengthen and build the government-to-government relationship between the United States and tribal nations, and I appreciate the Committee's interest in these matters. I also wanted to highlight that the Treasury Department submitted a report to Congress in December 2011 on the Tribal Economic Development Bond provision which recommended a more flexible standard for tribal tax-exempt bond financing similar to the standard that applies to State and local governments. This report is available on the Treasury website (see (http://www.treasury.gov/resource-center/tax-policy/Documents/Tribal-Economic-Development-Bond-Provision-under-Section-7871-of-IRC-12-19-11.pdf).Thank you for your patience as we work through the technical aspects of administering the general welfare exclusion and facilitating tribal bond issuance.

This concludes my testimony and I would be happy to answer any questions you might have.

**Statement Submitted for the Hearing Record**
**Committee on Finance**
**May 15, 2012**

# Federal Tax Reform and the Impact on the Territories

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# Federal Tax Reform and the Impact on the Territories

Chairman Baucus, Ranking Member Hatch, and Members of the Committee–on behalf of the Congressional Research Service, I thank you for the opportunity to appear before you today.

I have been invited here today to discuss how tax reform could affect the territories. In this testimony, I will briefly summarize the U.S. tax treatment of the territories.[1] I will then discuss a selected number of expiring provisions (commonly referred to as tax extenders) pertinent to the territories. Finally, I will outline how tax reform may affect the territories.

Federal tax reform will have an impact on the territories in two ways. First, American Samoa, Guam, the Commonwealth of the Northern Marianas, and the U.S. Virgin Islands each mirror the U.S. federal tax code. Simply put, this means the territories use the United States tax code as it is written, replacing the words "United States" with the territory name "U.S. Virgin Islands," for example. As a result, when the U.S. tax code changes so does their tax code in these territories. Puerto Rico, in contrast, has an independent tax regime, though it is modeled on the U.S. tax code. Secondly, there are specific provisions in the U.S. tax code that directly benefit one or more of the territories. This group of provisions is often found in so-called "extenders" legislation; three extenders are examined in this testimony.

## Territories and Taxation

The U.S. taxes residents and corporations located in the territories differently than if they resided in the United States. For individuals residing in the territories, their tax treatment is most similar to the tax treatment of foreign citizens. Generally, territorial residents are exempt from federal taxes on territory-sourced income but are—with some exceptions—taxed on income sourced in the U.S. In contrast, U.S. residents are subject to federal taxes on their territory-source income as if it were foreign-source income. However, territorial taxes can generally be claimed as foreign tax credits to offset U.S. tax liability. Thus, as with foreign-source income, the United States concedes primary tax jurisdiction to the territory where the income is earned. With some exceptions, it retains primary tax jurisdiction over U.S. sourced income earned by territorial residents.

Corporations chartered in the territories are treated like foreign-chartered corporations under the Internal Revenue Code (IRC). In principle, they are exempt from federal taxes on territorial income; U.S. firms that invest in the territories through subsidiaries can—at least potentially—defer federal taxes on territory earnings. Generally, U.S. taxes are paid only when earnings are repatriated to the domestic parent, with the U.S. tax reduce by the foreign tax credit. In the past, most U.S. firms that operated in the territories, however, chose instead to use the now expired possessions tax credit (IRC Sec. 936).

The impact of United States tax reform on the territories would depend in large part on the specifics of U.S. tax reform and how the territories responded to the changes. One option would be for these territories to decouple from the mirror system. American Samoa, Guam, and the Commonwealth of the Northern Marianas each have pending negotiations with the U.S. about ending the mirror system and coordinating with the United States on a new territory tax system. This option would allow the territories to be largely unaffected by U.S. tax reform, unless they choose to enact similar reforms. Alternatively, continuing with the mirror system the territories would incorporate the federal changes.[2] If the changes focus on increasing the progressivity of the federal tax code with higher rates for higher income

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[1] These are the five major territories. American Samoa, Guam, and the U.S.V.I. are "possessions" whereas the Northern Marianas and Puerto Rico are "commonwealths."

[2] The U.S. Virgin Islands does not have the option of implementing an independent tax structure.

earners, the impact on the territories would likely be muted as average income is significantly lower in the territories. In any case, this option would effectively cede control of the territories' tax systems to the U.S.

## Puerto Rico

Puerto Rico (PR) levies separate individual and corporate income taxes under the Puerto Rico Internal Revenue Code. The U.S. Internal Revenue Code, section 933, deems that income earned by a bona fide PR resident from sources inside PR is excluded from U.S. income. The Puerto Rican income tax is structured with generally lower statutory rates, compressed bracket ranges, and lower exemption amounts.[3] Rates range from 7% to 33% for taxable income in excess of $61,300 in 2012. (In comparison, U.S. individual income tax rates range from 10% to 35%.) Also in 2012, a 5% surtax is applied to taxable incomes above $200,000 and taxpayers must also calculate an alternative minimum tax (AMT), which is similar in operation to the U.S. version of the individual AMT. PR employers and employees are subject to the payroll taxes, FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act).

PR's corporate income tax consists of a normal tax and surtax whose rates combine to a top corporate tax rate of 39%. At the same time, however, certain types of firms may qualify for substantially reduced taxes under PR's industrial incentives program.[4]

## U.S. Virgin Islands[5]

The U.S. Virgin Islands (USVI) imposes a mirror tax system. Any changes to U.S. tax law are automatically incorporated into the USVI code. For individual income tax filers, bona fide residents of the USVI without U.S. sourced income need only to file with the USVI government. USVI residents with U.S. sourced income file U.S. returns, but can claim a foreign tax credit for the taxes paid to the U.S. on their USVI returns.

Corporations formed in the USVI pay taxes to the USVI based on worldwide income. These USVI corporations can claim foreign tax credits for taxes paid to jurisdictions other than the USVI including the United States. IRC Section 934 allows for the USVI to provide special income exclusions for entities operating in the USVI. The intent of this section of the U.S. Code is to allow the USVI to offer economic development incentives for certain types of businesses.

## American Samoa

American Samoa (AS) has what operates as a "mirror" tax system, though technically the AS tax is a local tax and AS residents are still responsible for U.S. taxes. They file in both the U.S. and AS, but all AS source income is excluded for purposes of U.S. income taxes.[6] Unlike the other territories, the AS tax structure does not "replace" the U.S. federal tax. The AS tax, however, is a territorial tax that is modeled after the U.S. federal tax.

Corporations in AS calculate taxes for the AS corporate tax just as U.S. corporations calculate taxes for U.S. corporate taxes and claim foreign tax credits for taxes paid to other countries, including the U.S.

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[3] Puerto Rico has a "0%" bracket amount which is similar in effect to an exemption. In 2012, the first $6,500 of taxable income is taxed at the 0% rate.

[4] A description of Puerto Rico's industrial incentives tax program is located at http://www.puertoricodoesitbetter.com/en/how-to-invest/incentives/Pages/default.aspx.

[5] See 48 U.S.C. 1397 and 48 U.S.C. 1642 for the legal background the USVI tax structure.

[6] Section 931 of the U.S. tax code.

## Guam

Guam employs a mirror tax system that is outlined in IRC Section 935. This section, however, was repealed by the Tax Reform Act of 1986, (TRA86, P.L. 99-514), conditioned on the U.S. and Guam agreeing to an implementation agreement for future tax coordination. That agreement has not been reached, thus IRC Section 935 still applies for Guamanian residents. The U.S. Treasury in some instances does collect taxes on Guam-sourced income and from withholding on U.S. Federal personnel employed or stationed in Guam. Generally, the U.S. Treasury returns (or "covers over") tax collected on Guamanian-sourced income to the Treasury of Guam.[7] Guam returns the favor and sends to the U.S. Treasury tax revenue collected on U.S. sourced income. In FY2012 the U.S. Treasury will cover over approximately $53 million to the Guam Treasury for the so-called "Guam Section 30 Income Taxes."[8]

Corporations formed in Guam pay the Guam corporate income tax, which mirrors the U.S. corporate income tax.

## Commonwealth of the Northern Mariana Islands

The Commonwealth of the Northern Mariana Islands (CNMI) also employs a mirror tax system. The CNMI mirror code is linked to Guam's mirror code with the important exception that if Guam does develop its own independent tax code, CNMI is not required to follow suit. The CNMI, like Guam, is authorized to implement its own tax regime (or non-mirror system) if an implementation agreement can be reached between the CNMI and the U.S. Internal Revenue Service (IRS). CNMI has also been authorized to rebate a significant portion of taxes paid on CNMI sourced income. According to the Joint Committee on Taxation (JCT), these rebates can range from 50 to 90 percent for individuals.[9]

Corporations formed in CNMI pay the CNMI corporate income tax, which mirrors the U.S. corporate income tax. As with CNMI individual taxpayers, corporations are also eligible for rebates on their CNMI taxes that range from 50 to 90 percent.

# Provisions in U.S. Tax Code Benefitting the Territories

The U.S. tax code includes at least three provisions that directly benefit taxpayers that have income from activities in the territories or that are resident in the territories. If tax reform were to include scaling back tax expenditures generally, one or all of these may be curtailed or eliminated.

### 1. Deduction allowable with respect to income attributable to domestic production activities in Puerto Rico (sec. 199(d)(8))

U.S. based entities, either individuals or corporations, are allowed to deduct 9% of taxable income that was earned in Puerto Rico. The deduction lowers the marginal effective tax rates of taxpayers in the highest bracket amounts to just under 32%. This confers a tax advantage

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[7] 26 U.S.C. 7654.

[8] U.S. Department of the Interior, Office of Insular Affairs, "Budget Justifications and Performance Information: FY2013," p. 7.

[9] U.S. Congress, Joint Committee on Taxation, "An Overview of the Special Tax Rules Related to Puerto Rico and an Analysis of the Tax and Economic Policy Implications of Recent Legislative Options," JCX-24-06, June 23, 2006.

for these entities because like situated entities without Puerto Rican or U.S. sourced income cannot claim the same deduction and thus are taxed at a higher marginal rate.

This special provision expired on December 31, 2011. The President's FY2013 Budget proposes extending this provision through 2013. The expected revenue impact would be a reduction in federal revenues of $312 million over the three year window of FY2012 through FY2014.[10]

### Impact of tax reform

If Congress chooses to broaden the base of both the individual and corporate income tax, they may choose to eliminate this special provision for entities with Puerto Rico-sourced income. The result may be some shifting of activity away from Puerto Rico, though the magnitude of this shift would seem minimal, especially in the short term, as much of the activity generating the income may not be easily or quickly shifted out of Puerto Rico.

If Congress chooses additional structural reforms, such as lower overall rates, the value of the deduction to taxpayers would decline. If, for example, the top rate for the U.S. corporate income tax were to drop from 35% to 25%, the after deduction marginal tax rate would be 9% of a smaller number (a 3.15 percentage point reduction compared to a 2.25 percentage point reduction). The size of this change would seem unlikely to significantly influence capital flow to and from Puerto Rico.

## 2. Temporary increase in limit on cover over of rum excise tax revenue (from $10.50 to $13.25 per proof gallon) to Puerto Rico and the Virgin Islands.

The United States levies a $13.50 per proof gallon excise tax on distilled spirits produced in or imported into the United States. Through 2011, $13.25 per proof gallon of *all* imported rum is transferred or "covered over" to the Treasuries of Puerto Rico (PR) and the United States Virgin Islands (USVI). The Caribbean Basin Economic Recovery Act of 1983 (P.L. 98-67) provides that all revenue from federal excise taxes on rum imported into the United States from any source—including any foreign country—is remitted to the treasuries of PR and the USVI.

In FY2011, PR received over $449.1 million in revenue and the USVI received $155.1 million.[11] The law does not impose any restrictions on how PR and USVI can use the transferred revenues. Both territories use some portion of the revenue to promote and assist the rum industry. Reports of the size of the subsidy vary considerably, though the amount ranges from roughly 6% of the covered over revenue in PR up to 18.5% in the USVI as of 2009.[12]

Beginning on January 1, 2012, the amount covered over to PR and the USVI reverted to $10.50 per proof gallon. The President's FY2013 Budget proposes extending the $13.25 rate retroactively through 2013. The expected revenue impact of extending the proposal will be a reduction in federal revenues of $222 million over the three-year budget window of FY2012 through FY2014.[13]

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[10] U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal," JCX-27-12, March 14, 2012.

[11] The data for Puerto Rico are from an e-mail correspondence with Carol Coy, Alcohol and Tobacco Tax and Trade Bureau, National Revenue Center, April 26, 2012. The USVI data are from: U.S. Department of the Interior, Office of Insular Affairs, "Budget Justifications and Performance Information: FY2013," p. 7.

[12] For more on the cover over, see: CRS Report R41028, *The Rum Excise Tax Cover-Over: Legislative History and Current Issues*, by Steven Maguire.

[13] U.S. Congress, Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal," JCX-27-12, March 14, 2012.

### Impact of tax reform

Allowing the higher payment to expire permanently as part of tax reform would have a direct impact on the governments of PR and the USVI. In the near term, the reduced payments from the U.S. could adversely impact economic development projects that are tied to the anticipated revenue streams. For example, the USVI has issued debt secured by future cover-over revenue to finance the construction of rum producing facilities. Over the longer term, however, the USVI would incorporate the reduction from $13.25 to $10.50, into future economic development plans.

An even more substantial reform, such as repealing the cover over for rum not produced in PR or USVI (or termination of the cover over completely) would be significantly more disruptive to the island economies.

To the extent the covered over revenues are used to subsidize rum producers in PR and the USVI, the current subsidy may: (1) reduce the price of PR and USVI produced rum relative to other countries' production of rum and distilled spirits; (2) increase the rate of return of capital invested in the subsidized producers; and (3) increase worker earnings in the subsidized production facilities. The relatively competitive market in the United States for distilled spirits and existing labor market characteristics of PR and USVI could lead one to conclude that the subsidy is largely realized in an increased rate of return to capital for investors in the subsidized producers.

From an economic efficiency perspective, this analysis implies that subsidy-receiving rum producers are earning a higher rate of return than would be the case absent the cover over and related government subsidy. Some observers have suggested that this outcome may be at odds with the intent of the cover-over program. However, Congress has indicated that the use of the cover-over revenue is best left to the Territorial Government.

In the Senate report language accompanying the Revised Organic Act of 1954, Congress expressed a desire that the USVI use the covered-over revenue to loosen the dependence of the USVI on periodic appropriations from the U.S. government. According to the report language, under a cover-over system, "the people of the Virgin Islands would have a far greater degree of control over their finances than under the present system."[14] The report continues, recommending that "the people of the Virgin Islands bend their efforts to stimulating and increasing business in every way possible."[15]

### 3. American Samoa economic development credit

A domestic corporation is allowed a credit for operations in American Samoa (AS) to offset U.S. corporate tax liability. Generally, the credit is limited to the amount of U.S. corporate tax liability generated by AS sourced income. The credit was intended to replace the expired possessions tax credit (sec. 936) and as such is limited by the tax code with language contained in the repealed sec. 936.

The President's FY2013 Budget proposes extending the credit retroactively through 2013. The expected revenue impact of extending the proposal would be a reduction in federal revenues of $21 million over the three-year budget window of FY2012 through FY2014.

## Tax Policy in General

Economists typically evaluate tax policy based on three principles: equity, efficiency, and administrative simplicity. The current mirror tax structure in the territories means that federal

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[14] U.S. Congress, Senate Report to Accompany S. 3378, *Revision of the Organic Act of the Virgin Islands*, Report no. 1271, 83rd Congress, 2nd sess., April 29, 1954, p. 5.
[15] Ibid., p. 6.

tax reform would, in most cases, automatically change territorial tax systems. If tax reforms move the U.S. tax code closer to a more equitable, efficient, and administratively simpler tax regime, then the territorial system could move in the same direction as well. If the territories, however, respond by decoupling their tax systems from the U.S. tax code or abandoning the mirror system, there may be negative consequences for the three principles described above.

The intergovernmental tax context has two perspectives to consider: horizontal and vertical. Horizontal equity, efficiency, and administrative simplicity refers to the coordination among governments at the same level. For the 50 states, this could be achieved with tax coordination among states for taxes that are levied on the same base—such as income and sales taxes. For territories, coordination is less important as economic interaction among the five major territories is limited—with the exception of the U.S. Virgin Islands and Puerto Rico. A mirror system would seem to provide such coordination. Within each territory, however, the parameters of the U.S. code, which are geared to the large and dynamic U.S. economy, may not be appropriate for the territorial economies. Thus, decoupling from the U.S. code may create a more equitable and efficient tax regime within a given territory. Among territories, however, potentially different tax regimes may induce taxpayer behavioral changes that can increase the economic burden of taxes generally.

Vertical coordination, in contrast, would be between governments at different levels. The existing mirror structure seems to be a reasonable attempt at coordinating the tax regimes of the U.S. federal government and the territories. Abandoning the mirror system would likely increase compliance and administrative costs for taxpayers with territory and U.S. sourced income.

The possibility of federal tax reform will have an impact on the territories. The magnitude of that impact will depend on the nature of federal reform and how the territories respond.

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# TESTIMONY OF ROBERT ODAWI PORTER
# PRESIDENT OF THE
# SENECA NATION OF INDIANS

before the

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

## HEARING ON
## TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES

May 15, 2012

### INTRODUCTION

Nya-weh Ske-no. Chairman-and-Senator Baucus, Ranking Member-and-Senator Hatch, and members of the Committee, I am thankful that you are well and I am pleased to appear today to discuss briefly my written testimony on "the promise of tax reform" for American Indian Nations. I ask that my written testimony be placed in the record on behalf of the Seneca Nation of Indians, which I lead as its elected President.

### BACKGROUND ON THE SENECA NATION OF INDIANS

The Seneca Nation of Indians ("Nation") is one of America's earliest allies, historically aligned with the other members of the historic Haudenosaunee (Six Nations Iroquois) Confederacy and living in peace with the American people since the signing of the Canandaigua Treaty over 217 years ago on November 11, 1794, 7 Stat. 44. Our Nation has entered into numerous treaties and agreements with the United States since that time and we have always sought to live up to our side of this relationship, despite repeated instances in which the United States has not done so.

The key promises made to us by the United States in the Canandaigua Treaty are that it would recognize the Seneca Nation as a sovereign nation, that it would ensure that our property and activities would not be taxed, and that it would forever secure our title to our lands. The United States expressly guaranteed that we would retain the "free use and enjoyment" of our lands. This promise has served as the basis for a level of freedom possessed by the Seneca people that is among the highest levels of all indigenous peoples in the United States.

Because of this treaty-protected freedom, our Nation has been able to achieve some success in recovering from nearly 200 years of economic deprivation inflicted upon us by the United States due to devastating losses of our lands and resources. Both our Nation government and individual Seneca citizens have benefited from the opportunity to trade with non-Indians during the last 40 years, focusing primarily on available business involving tobacco, gambling and ancillary ventures. We have fought hard for our recent economic success – just as we have fought hard to protect our lands – but the fact remains that we are under constant assault from hostile forces -- such as the State of New York and private sector predators -- who seek to deprive us of economic prosperity and return us to the poverty of a prior era.

## TAX REFORM SHOULD ADHERE TO THE FIRST PRINCIPLES OF FEDERAL INDIAN LAW AND POLICY: – *TRIBAL NATIONS ARE GOVERNMENTS WITH TERRITORIAL SOVEREIGNTY*

We have long believed that our treaties with the United States require that the Seneca Nation, our people and our lands, be treated as immune from federal and state taxation. By legislation and agreement, the United States has generally recognized this tax immunity and our Nation's inherent, sovereign right to regulate all conduct within our Territories free of interference by all other governments. Moreover, the Congress has never expressly authorized the direct taxation of individual Indians.

However, many aspects of our treaty-recognized freedoms have been eroded over time, particularly those that originally protected our individual tribal citizens. All three branches of the federal government -- judiciary, executive, and legislative -- have directly caused or allowed this erosion to occur. Without any express Congressional authorization, over the last 60 years the Treasury Department has forced tribal citizens to become taxpayers in violation of our treaty status. Forcing us to pay taxes – such as income taxes, payroll taxes, and excise taxes – undermines our treaty-protected immunities. It must be remembered that our treaties with the United States reflect the payment of our "tax bill" in perpetuity – Indian people gave up nearly all of our lands in fulfillment of any and all obligations that might ever be owed to the United States in the future.

I recount this history for a reason. There is a direct link between the harsh poverty and devastating unemployment that has long existed in Indian Country and the taxation and regulation by other governments of activities in our tribal territories. While there are many factors that contribute to the economic underdevelopment of Indian Country, tax burdens

imposed by external governments contribute to making Indian Country in some cases the last place in America where meaningful capital investment and job creation will occur.

With this backdrop, I suggest that the promise of tax reform will have the most impact if it advances the first principles that are at the foundation of federal Indian policy at its best -- ***tribal nations are governments whose exclusive authority to govern all economic activity on their territory is fully respected as a matter of federal law***. Resurrecting this ***tribal territorial sovereignty*** approach should be the focus of any new, bold tax reform efforts. If the goal is to increase economic growth in Indian Country, tribal territories must be recognized as places of economic opportunity for tribal governments and tribal citizens.

## KEEP IT SIMPLE WHEN CRAFTING TAX REFORM FOR INDIAN COUNTRY

Many of the good people in this room have spent the past several decades creating and reauthorizing a string of tax reform efforts with the best of intentions for improving the economies of Indian Country. These tax reform ideas may have worked for the hundreds of investors, bankers, lawyers, accountants, consultants and government administrators who sought to implement these efforts. But the fact is that these efforts simply have not worked -- for Indian Country in Montana, or South Dakota, or New York, or anywhere else:

- "Investment tax credits,"
- "Accelerated depreciation for qualified Indian reservation property,"
- "Employment tax credits,"
- "Renewal communities,"
- "Work opportunity tax credits,"
- "20% wage-credits-for-the-first-$15,000-of-wages-in-new-jobs-in-empowerment zones,"
- "20%-of-the-excess-of-eligible-qualified-wages-and-health-insurances-costs-that-an-employer-paid-or-incurred-during-the-tax-year-over-the-amount-of-such-costs-that-an-employer-paid-or-incurred-during-the-prior-year,-but-only-up-to-the-first-$20,000-of-aggregate-qualified-wages-and-health-insurance-costs-paid-for-each-qualified-employee-in-a-taxable-year."

With all due respect, these complicated schemes have not worked in Indian Country. Their complexity and minimalism have stifled all practical benefit. They may be motivated by good intentions but they have produced little earthly good for Indian Country. Drive through most Indian territories in the Great Plains or almost anywhere else in Indian Country and that's what you will see -- painful proof that all these good but complicated tax reform ideas have not amounted to much.

I urge you to once-and-for-all make tax reform work in Indian Country for tribal businesses and individual entrepreneurs. To do that, you have to keep it simple. Keep it simple so that it can be implemented without requiring Indian people to hire an army of expensive bankers, lawyers, accountants and brokers. Keep it simple so that local businesses can flourish, generate income

for Native people, and help move our nations away from the grinding rut of intergenerational poverty.

## PURSUE SUCCESS WITH A DEMONSTRATION PROJECT THAT NARROWLY TARGETS TRIBAL TAX EMPOWERMENT ZONES WHERE THEY WILL DO THE MOST GOOD

The past two decades of federal tax policy failures in Indian Country make a compelling case for trying something different based on ***tribal territorial sovereignty***. Can anyone point to any significant economic benefit for Indian Country that was derived from the Indian reservation employment and investment tax credits that Congress repeatedly has extended, often at the midnight deadline, for the past two decades? These wage and investment tax credits have not been large enough, or of long enough duration, or simple enough to administer, to induce the private sector to invest and locate new jobs in Indian Country.

Why hasn't Congress made these Indian tax credits larger? Because the employment and investment tax credit packages have made all of Indian Country -- tens of millions of acres and hundreds of Indian Nations -- eligible for tax relief.[1] This broad scope of eligibility has required Congress to water down the tax reform benefits to useless levels because the scoring rules, driven by the potential immunity of millions of acres and people, have generated far too costly scores to be included in any comprehensive tax incentive package.

Given the political and financial realities of the day, I suggest the Committee take a different, more targeted approach. One that better respects federal treaties with our nations and federal self-governance policy. One that promises real and meaningful economic benefit. And one that supports tribal territorial sovereignty.

Instead of dialing back potential tax incentive benefits to useless levels, I urge you to declare unlimited tax immunity within a limited number of footprints in Indian Country for a limited number of Indian nations. In other words, I suggest you shape tax reform law so as to restore complete tax immunity in a demonstration or pilot project that is constrained in order to make it cost feasible but with unlimited benefits to facilitate its success. Such a pilot project will demonstrate that a tribal empowerment zone immune from all governmental tax (other than tribal taxes or fees) has the greatest promise of creating a thriving, jobs-producing private sector in Indian Country where it otherwise would never occur. If it works, this policy could be expanded in the future. If it does not work, the outcome would be no worse than the application of the current failed policy.

Accordingly, I ask that you consider a demonstration or pilot project that is limited to several dozen Tribal Empowerment Zones, of limited acreage, established by the federal and tribal governments. Since, as a practical matter, tribal nations will seek to economically develop only

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[1] There are 566 federally-recognized Indian nations who count as their homelands about 57 million acres of Indian Country in the continental United States, plus an additional 45 million acres in Alaska (although the U.S. Supreme Court has ruled that most of the Alaska acres are something less than Indian Country).

relatively small portions of their territories, why not limit the number of Tribal Empowerment Zones to 50 zones for 50 tribal nations and the number of acres in each zone to 50? In this way, the scoring could be focused on feasible development projects and the total pool of available credits not go unused. In effect, these tax-free economic islands will function like an oasis in a dry desert, importing and recycling money into Indian Country and giving economic life to tribal societies where it may not have existed for generations.

I can envision this tax reform idea inducing a manufacturing company to locate in Indian Country rather than relocating to India. I can also see this approach inducing a grocery store chain to relocate a store in Indian Country rather than avoid the perceived risks of doing business on Indian lands. Instead of the Indians having to live in poverty because there is no work, jobs can be created on the reservation. Instead of Indians having to drive long distances for basic food supplies, stores can be located near where people live. This is not an outrageous idea, but simply bringing to Indian Country much of what the rest of America already has at its fingertips.

It is worth mentioning that I believe that creating tax-immune development Zones will likely bring benefit to both Indians and non-Indians on and near tribal lands. Given some of the labor and capital deficiencies in Indian Country, non-Indian companies and workers can provide stable partners for developing tribal economies. I have seen in my own Nation – both from our gaming and tobacco businesses -- that it is hard for Indian Country to "go it alone" on the path of success; working in economic partnership with non-Indians is an inevitable reality of reservation re-development. If the United States can restore proper respect for the first principles of federal Indian policy – that Indian nations are governments with territorial sovereignty – all people can benefit.

I have attached some legislative language for your consideration and discussion. It builds upon my scholarship as a law professor for the last 15 years and my experience as my Nation's President over the last year and a half in which I have traveled throughout Indian Country and back and forth to Capitol Hill to encourage my fellow tribal leaders and their supporters in Congress to take a bold step toward restoring economic prosperity for Indian Country other than through gaming.

You will see some similarity between this proposal and the New Market Tax Credit programs with which you are familiar. As to other proposals for tax reform, I commend to the Committee's attention the excellent written testimony submitted by the National Congress of American Indians and the United South and Eastern Tribes. In order to enhance the promise of a greater impact, however, I have made my pilot proposal more narrow and more deep.

## DETAIL OF PROPOSED LEGISLATION FOR A TAX REFORM DEMONSTRATION PROJECT CREATING TRIBAL EMPOWERMENT ZONES

Premise. Private sector economic development has by-passed much of Indian Country, especially that which is not engaged in tribal government gaming. The re-establishment of tax-free zones in selected areas of Indian Country will attract private enterprise to locate in Indian Country and bring economic activity that promotes entrepreneurship, creates jobs, and brings trade in goods and services closer to the local Indian community.

Eligibility. The bill would establish up to 50 Tribal Empowerment Zones of up to 50-acres each. Half of the Zones would be reserved for applicant Indian tribes with an unemployment rate exceeding 50% under the latest annual BIA workforce reports. The remaining half of the Zones would be awarded to applicant Indian tribes who competitively demonstrate the strongest available tribal institutions fostering effective and stable self-government, predictable legal infrastructure, and tribal policies facilitating entrepreneurial economic development and a business-friendly climate. The Secretaries of the Treasury and Interior would collaborate in establishing the zones.

Tax Benefit. The bill would declare each selected Tribal Empowerment Zone to be a tax-free territory immune from all federal, state and local income, sales, and excise taxes with the exception of so-called payroll taxes (e.g., social security, Medicare/Medicaid). The tax immunity would apply to all economic activity located within that Zone, and sunset after a period of ten years following which all federal taxes otherwise applicable would apply.

## CONCLUSION

The shortcomings of the past and present tax policies justify a bold initiative in the area of tax reform to benefit Indian Country. The reasons for doing so are many.

There is no question that current federal tax incentive policies for Indian Country have not worked -- just look at the persistent poverty and unemployment statistics that enslave Indian Country. Aside from those few places where gaming has succeeded, Indian Country remains chronically underdeveloped and impoverished. Economic survival in Indian Country is largely dependent upon federal transfer payments.

Just as federal law acknowledged tribal sovereignty and protected Indian gaming in the middle of non-gaming markets to allow billions of dollars of investment to flow into Indian Country, tax reform could likewise create islands of tax-free Tribal Employment Zones that attract private sector investment into Indian Country. Federal politicians have long sought ways to support non-gaming development in Indian Country and promote growth and diversification -- this tax reform initiative is a practical way to make it happen.

Basic morality and the standards of international law suggest that American Indians should not be consigned to live in the most impoverished places in America. Article 21 of the U.N.

Declaration on the Rights of Indigenous Peoples – which is supported by the United States – provides that "[i]ndigenous peoples have the right, without discrimination, to the improvement of [our] economic and social conditions" and that the United States "shall take effective measures to ensure continuing improvement of [our economic] and social conditions... ."

And lastly, federal law and treaties require that this Congress take action to respect our immunities from taxation and create conditions in which our "free use and enjoyment" of our lands can once again serve as the foundation of prosperity, not poverty. I suspect you may ask yourselves the question, "How can we favor this one group of people we call Native Americans from other groups of Americans?" Well, the answer, I respectfully suggest, is that we are citizens of our own sovereign nations with a treaty relationship with the United States. No other group of Americans can claim that simple, legal reality.

My hope is that you gather up all the effort and benefit for Indian Country that would otherwise be consumed by sophisticated investment tax credits, complex accelerated depreciation rules, and complicated wage credits -- all requiring elaborate legal superstructures that swallow most of Indian Country's benefit at desks in office buildings far from Indian Country -- and instead keep it simple. Just create tax-free Tribal Empowerment Zones in Indian Country and step back and let the private sector come into Indian Country in partnership with sovereign tribal governments and let the marketplace do its work.

Too often, we hear from Members of Congress only lip-service when it comes to truly helping our nations and our people. For the Seneca Nation, and I believe many others, we seek an economic future in which we are free to care for ourselves and our future generations without interference. If the Congress can resume the path of respecting our inherent and treaty-protected exclusive rights to control development in our lands, including the exclusive right to develop and regulate our own economies, I believe that the promise of our treaty relationship can be fulfilled. I strongly encourage you to pursue this bold initiative that will in a very simple way restore complete tax immunity to Indian Country and with it a real and practical opportunity for economic revitalization.

Thank you for this opportunity to provide testimony and I ask that it be made part of the record of this hearing.

Nya-weh.

Attachment: Proposed draft bill language for a demonstration project establishing tax-free Tribal Empowerment Zones

DISCUSSION DRAFT
MAY 15, 2012

# RESTORING TAX-FREE TRIBAL EMPOWERMENT ZONES ACT

*A bill to establish a pilot demonstration project to restore tax-free tribal empowerment zones in designated areas of Indian country, and for other purposes*

SEC. 1.—SHORT TITLE.

This Act shall be called the Restoring Tax-Free Tribal Empowerment Zones Act of 2012.

SEC. 2.—DEMONSTRATION PROJECT TO RESTORE TAX-FREE TRIBAL EMPOWERMENT ZONES.

(a) SELECTION OF PARTICIPATING TRIBES. — From among federally recognized Indian tribes applying to the Secretary of the Interior and Secretary of the Treasury, the Secretaries shall select up to 50 Indian tribes to participate, one-half of whom shall be from among Indian tribes with annual unemployment rates of greater than 50% in the American Indian Population and Labor Force Report most recently published by the U.S. Department of the Interior, Bureau of Indian Affairs, and one-half of whom shall be from among Indian tribes who competitively demonstrate the strongest available tribal institutions fostering effective and stable self-government, predictable legal infrastructure, and tribal polices facilitating entrepreneurial economic development and a business-friendly climate.

(b) EXEMPTION FROM TAX. — The Secretary of the Treasury shall designate all activities on lands identified in subsection (c) to be free of and exempt from

all otherwise applicable excise, sales, severance, property, income, transfer, individual, and corporate taxation by the United States or any State or subdivision thereof.

(c) IDENTIFIED LANDS. — The exemption from tax authorized in subsection (b) shall apply to all activities carried out on up to 50 contiguous acres of land, designated by the participating Indian tribe, in which the participating Indian tribe or an Indian individual holds beneficial interest and which are located within the limits of the Indian reservation of the participating Indian tribe as said Indian reservation is defined in Section 1452(d), Title 25, United States Code.

(d) DESIGNATED TAX EXEMPT ACTIVITIES. — The exemption from tax authorized in subsection (b) shall apply, on lands identified in subsection (c), to all activities carried out thereon by the Indian tribe or Indian individual holding beneficial interest in the land and by any other person or entity carrying out otherwise taxable activities thereon with the express permission of, and under terms established in the sole discretion of, the participating Indian tribe.

(e) SUNSET. — The authority provided in subsection (a), subsection (b), subsection (c) and subsection (d) shall extend from January 1 of the year following the date of enactment through December 31 of the year that is ten years after the date of enactment of this Act.

(f) SAVINGS.— Nothing in this Act shall be construed to diminish the Federal trust responsibility to Indian tribes or individuals nor to diminish the tax immunity of Indian tribes or individuals under laws in effect on the day before the date of enactment of this Act.

UNITED STATES SENATE COMMITTEE ON FINANCE

HEARING ON
"TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES"

TESTIMONY OF
LINDSAY G. ROBERTSON
JUDGE HASKELL A. HOLLOMAN PROFESSOR OF LAW
UNIVERSITY OF OKLAHOMA COLLEGE OF LAW

May 15, 2012

Good morning, Chairman Baucus, Ranking Member Hatch, and other distinguished members of the Committee.

My name is Lindsay Robertson and I am the Judge Haskell A. Holloman Professor of Law and Faculty Director of the Center for the Study of American Indian Law and Policy at the University of Oklahoma College of Law. I have been a professor of Federal Indian Law for more than 20 years. From 2000-2010, I served as Special Counsel on Indian Affairs for Oklahoma Governors Frank Keating and Brad Henry. It is an honor to have been invited to address this committee on this important topic.

I would like first to place the issue of tax policy and tribal economic life in historical perspective, then address potential reforms. While there are a number of areas in the Internal Revenue Code that could be improved to better serve tribes, input on which others, including President Porter and various organizations, will be providing the Committee, I will highlight two: the "essential government function" limitation on tribal tax-exempt bonding and current limitations on the application of the General Welfare Exclusion.

Tribal governments in the United States are both pre-constitutional and extra-constitutional. That is, they existed before European settlement and they operate apart from and not directly subject to the Constitution. The U.S. Supreme Court has characterized tribes as "domestic dependent nations" – nations, and not simply aggregations of individuals sharing a particular heritage, but domestic nations, not foreign nations, and therefore having a special relationship to the United States. In the same decision – *Cherokee Nation v. Georgia* – the Court described that relationship as being like that of "a ward to his guardian." In 1886, in *Kagama v. United States*, the Court recognized a substantive legal consequence to this relationship. As guardian, or trustee, the United States has power to legislate over Indian affairs, but also the responsibility to exercise that power to the ultimate benefit of the tribes.

In furtherance of its trust responsibility, since *Kagama* the United States at numerous stages has acted proactively to address what it perceived to be problems in tribal economic development. These efforts have been bipartisan. For example, the Indian Reorganization Act of 1934, President Franklin Roosevelt's key tribal legislation, established tribal economic development funds, authorized the creation of tribal corporations, and provided tribes the means to reestablish jurisdiction over lands lost during the allotment era of the late 19th Century, when collectively-

owned tribal lands were divided up and sold. The Self-Determination and Education Assistance Act of 1975, a Republican initiative, entrusted tribal governments with control over federal programs operating within their communities, in part on the theory that only in that way would these programs be truly accountable to the people they served.

Whether to comply with a trusteeship obligation grounded in law, or morality, or because it simply makes economic sense, the Congress has frequently employed its power to legislate tax policy to facilitate tribal economic development.

I would like now to say a few words in support of the two specific reforms I mentioned when I began my remarks.

The first is the elimination of the "essential government function" limitation on tribal tax-exempt bonds found in 26 U.S.C. § 7871. Tribes are now and have always been handicapped under federal law when it comes to the raising of capital for economic development activities. Since the Trade and Intercourse Act of 1790, tribal land sales without federal authorization have been invalid under federal law. While this restriction undoubtedly led to the retention of tribal lands that might otherwise been lost, it had the unintended effect of making tribal lands unavailable as security for conventional loans. Free alienability of such lands is not the solution as long as tribal jurisdiction is closely tied to land tenure. Instead, the solution must involve the creation of compensatory capital-generation devices. Authorizing tribes to issue tax-exempt bonds was a step in the right direction. However, the "essential government function" limitation imposed on the use of funds raised through such bonding limited its utility as an engine for economic development. It is worth noting that the "essential government function" limitation is not applied to limit the use of funds raised through tax-exempt bonding by states and municipalities. The elimination of the limitation on tax-exempt bonding by tribes would free tribes to raise capital otherwise unavailable to them and make it possible for them responsibly to create their own solutions in today's difficult economic times.

A second important tax reform involves the General Welfare Exclusion, which is currently interpreted to apply only to tribal means-tested programs. Tribal governments commonly provide benefits to their members including health, education and other services. Some of these, including, for example, language education, are considered essential for the preservation of tribal culture. When the United States taxes these benefits, tribes are handicapped in the services they can provide. Presently, it appears that not only are these services being taxed, they are being audited at a disproportionate rate. It is difficult to imagine that the revenue generated by the taxation of these services outweighs the harm done to tribal governmental operations and cultural preservation. Moreover, where services are provided to make up for deficiencies resulting from adverse conditions not of the tribes' making or, indeed, to further federal policy objectives, taxing and auditing them appears to me inconsistent with the requirements of the federal trust responsibility.

I thank you for holding this hearing and for allowing me the opportunity to appear. I would be happy to answer any questions.

Thank you.

**Response From Dr. Lindsay Robertson to a Question for the Record**
**"Tax Reform: What It Could Mean for Tribes and Territories"**
**May 15, 2012**

***Question from Senator Hatch***

*Question:* President Porter in his written testimony is critical of many of the tax provisions that have been enacted in the past in order to aid Indian Country, and in his testimony he specifically notes that many of the tax provisions enacted in the past were not for a long enough period of time. When discussing any of the provisions that make up the tax extenders, the question always arises of the impact the temporary nature of these provisions has on their effectiveness. Of the ineffective tax provisions he lists in his testimony, are there any that would be useful but for their status as a tax extender? As part of tax reform, should we completely throw them away, or incorporate them in a different way?

*Response:* I believe that all of the listed provisions are useful despite their temporary status and that all might advantageously be incorporated as part of tax reform, especially if made permanent. Because they seem to be providing some benefit to tribes even in their current form, I would not advocate eliminating them.

As President Porter testified, the current tax provisions are problematic because they are temporary and complicated. I might add that, because they confer an indirect benefit on tribes, it is hard for tribes to assess the advantages they have brought in other than an anecdotal way.

Tribal economic stimulae without reliable longevity have always provided some, though less than optimal, benefit to tribes. Early federal land leasing statutes, for example, imposed maximum lease periods of as little as 5-10 years on leases of tribal lands, rendering investment in long-term capital improvements rare. When permissible lease periods were extended, capital investment increased. As noted, because the benefit that the provisions cited by President Porter provide to tribes is indirect, it is difficult for tribes to assess their effectiveness as contributors to economic growth. Anecdotally, it appears that investors are taking advantage of these programs, but not to the extent they would if those programs could be counted on to continue. To determine which programs have been most effective, I would recommend asking the Department of the Treasury to report on utilization. I agree with President Porter that simplifying the provisions would make them more attractive to potential investors and also facilitate the marketing of tribal economies.

# COMMUNICATIONS

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SUBMISSION OF WRITTEN COMMENTS FOR THE HEARING RECORD
U.S. SENATE COMMITTEE ON FINANCE

HEARING ON
"TAX REFORM – WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES"

MAY 15, 2012

Chairman Baucus, Ranking Member Hatch, and distinguished Members of the Committee:

Arctic Slope Regional Corporation (ASRC) is pleased to submit written comments for the record in connection with the May 15, 2012 Senate Finance Committee hearing on the important topic of tax reform and what it could mean for Tribes and Territories.

ASRC is an Iñupiat-owned Alaska Native regional corporation, formed pursuant to the Alaska Native Claims Settlement Act, 43 U.S.C. §1601, et seq. (ANCSA), that represents the business interests of the Iñupiat Eskimos of the Arctic Slope. ASRC's congressionally-mandated mission is to invest in its land base and business interests to provide in perpetuity for the well-being of our Iñupiat Eskimo shareholders.

As Congress continues to consider various issues of tax reform, ASRC would like to comment on three tax-related items of significant interest to ASRC:

- The taxability of Alaska Native Corporations (ANCs),
- The extension of credits for the production of ultra-low sulfur diesel (ULSD)
- The Outer-Continental Shelf contracting tax credit

Taxability of Alaska Native Corporations

ANCSA established Alaska Native Corporations to hold property for, provide meaningful financial benefits to, and to provide and protect the health, education and welfare of Alaska Natives. Unlike traditional public and private corporations, whose principal objective is to become profitable, Alaska Native Corporations are also charged with a congressionally mandated mission of preserving cultural practices, land, resources, and access to traditional areas of cultural importance. Alaska Native Corporations must focus on economic development and job creation as well as the social welfare of their shareholders; this dual purpose and mission has more affinity with Lower 48 Indian Tribes than with traditional corporations, and necessitates that Alaska Native Corporations act as both a business and a cultural institution. This dual mission thus

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requires that Alaska Native Corporations create and preserve more capital than a traditional corporation.

Notwithstanding the unique status of Alaska Native Corporations and the important role they play, Alaska Native Corporations are subject to the same Federal income tax treatment as other domestic corporations. Specifically, Alaska Native Corporations are subject to double taxation -- at the corporate level and again at the shareholder level. By comparison, Indian Tribes and wholly-owned tribal corporations chartered under Federal law are not subject to Federal income tax. They share similar missions of providing for their people, yet they are taxed very differently.

ASRC fully supports the exemption for Indian Tribes and wholly-owned Tribal corporations, and is not advocating for a change in their tax regime. Rather, the point to be made is that the double taxation model significantly hinders the ability of an Alaska Native Corporation to carry out its congressionally-mandated mission.

Alaska Native Corporations are taxed as mainstream, ordinary corporations. Yet their mission is anything but ordinary. They are not sovereign governments and currently are not exempted from Federal income tax like Tribes and tribally-owned corporations. However, Alaska Native Corporations, like Tribes, also play a vital role in the lives of their shareholders, many of whom live in the most remote and difficult regions of this nation. ASRC believes that taxation of Alaska Native Corporations is inconsistent with Federal Indian policy. Further, the double taxation of Alaska Native Corporations decreases the amount of available capital for investing in fulfilling the cultural and financial aspects of their mission.

The burden of double taxation of an Alaska Native Corporation is borne by its shareholders who must pay a second level of tax on the dividends received from the corporation. Alaska Native Corporations are both a corporate and social entity on whom its shareholders rely for economic and social support. ASRC believes that this special, indeed, unique relationship should be afforded different tax treatment, specifically, only a single level of taxation.

As Congress and this Committee study ways to reform the Internal Revenue Code as it applies to Native peoples, ASRC urges that the Internal Revenue Code be amended to impose a single level of taxation on Alaska Native Corporations.

Ultra Low Sulfur Diesel Fuel ("ULSD")

The U.S. Environmental Protection Agency has required all small refineries which produce ULSD to reduce the sulfur content from 500 ppm to 15 ppm. To help small refiners overcome the financial burdens associated with this EPA mandate, Congress included two tax provisions in the 2003 Energy Policy Act. IRC section 179B allowed refiners to expense 75% of the capital costs of meeting the EPA rules, and IRC section 45H provided a 5-cent per gallon tax credit for diesel produced by small refiners capped

at 25% of the cost of the refinery upgrade. The two ULSD tax benefits applied only to costs incurred prior to the end of 2009.

Relevant to these comments, ASRC owns and operates Petro Star Inc., one of three refining companies in Alaska, and the only Alaska-owned or small business refiner in the state. Petro Star has two refining facilities, one in North Pole and the other in Valdez, Alaska.

Petro Star undertook the initial steps to design and construct the capacity to produce ultra-low sulfur diesel fuel at its Valdez Refinery in 2007 with an expected completion date of early 2010. This schedule made sense because under EPA rules, ultra-low sulfur diesel was not required in rural Alaska until June 1, 2010 (and marine diesel for Dutch Harbor is a major product of the Valdez refinery). However, midway in this process, (December 2008), the Valdez Refinery experienced a major fire, causing significant damage to the process unit. Reconstruction of the damaged units was complicated by Valdez's severe winter weather conditions and remoteness, as well as long delivery times for specialized equipment items. Moreover, while reconstruction from the fire was proceeding, Petro Star was simultaneously working to install the process units necessary to produce ULSD. Running parallel engineering and construction projects of this magnitude ultimately delayed completion of its new ULSD facilities until November 2010.

Unfortunately, construction delays attributable to the Valdez fire and the mismatch between the small business refiner compliance deadline and the sunset date of Sections 45H and 179B (June 1, 2010 and December 31, 2009, respectively) meant that much of Petro Star's otherwise qualifying ULSD capital costs were excluded from contributing the essential tax benefits that Congress intended. An effective solution would be a temporary extension of the deadline for qualifying expenditures for the two ULSD provisions (effective January 1, 2010). Such an extension will ensure that small business refiners that stepped up and complied with the federal environmental mandate will not suffer enduring financial harm which could further jeopardize the long term viability of these vital suppliers of diesel fuels to rural and remote areas.

Outer-Continental Shelf (OCS) Contracting Tax Credit

As Congress and the Administration focus their efforts on responsibly increasing the domestic supply of oil and gas, many development opportunities will occur on or near Native lands and communities that border the outer-continental shelf region. While such energy development contributes to increased domestic energy supplies and protects our national security, there are no incentives available to industries to encourage partnering with the Native organizations or communities that are most affected by this potential development. ASRC believes that tax incentives should be provided to OCS explorers to encourage companies to join with Native-owned firms in developing the OCS region.

Support for Tribal Taxing Authority

ASRC also would like to express its support for legislation sought by Indian Tribes that would affirm exclusive tribal authority to tax energy activities on Indian lands. Such legislation would clarify Federal case law that has allowed unlimited dual state and tribal taxation on Indian lands without any regard to the chilling effect such a burden puts on Reservation energy development.

* * * * * * * *

We thank the Committee for considering these very important aspects of tax reform and allowing us the opportunity to participate in the process.

Sincerely,
ARCTIC SLOPE REGIONAL CORPORATION

Rex A. Rock, Sr.
President and CEO

**Comments for the Record**

**Senate Finance Committee**

**Tax Reform: What It Could Mean for Tribes and Territories**

Tuesday, May 15, 2012, 10:00 AM

By Michael G. Bindner
Center for Fiscal Equity
4 Canterbury Square, Suite 302
Alexandria, VA 22304

Chairman Baucus and Ranking Member Hatch, thank you for the opportunity to submit these comments for the record to the Senate Finance Committee. As always, our comments are in the context of our four part tax reform plan:

- A Value Added Tax (VAT) to fund domestic military spending and domestic discretionary spending with a rate between 10% and 13%, which makes sure very American pays something.
- Personal income surtaxes on joint and widowed filers with net annual incomes of $100,000 and single filers earning $50,000 per year to fund net interest payments, debt retirement and overseas and strategic military spending and other international spending, with graduated rates between 5% and 25% in either 5% or 10% increments. Heirs would also pay taxes on distributions from estates, but not the assets themselves, with distributions from sales to a qualified ESOP continuing to be exempt.
- Employee contributions to Old Age and Survivors Insurance (OASI) with a lower income cap, which allows for lower payment levels to wealthier retirees without making bend points more progressive.
- A VAT-like Net Business Receipts Tax (NBRT), which is essentially a subtraction VAT with additional tax expenditures for family support, health care and the private delivery of governmental services, to fund entitlement spending and replace income tax filing for most people (including people who file without paying), the corporate income tax, business tax filing through individual income taxes and the employer contribution to OASI, all payroll taxes for hospital insurance, disability insurance, unemployment insurance and survivors under age 60.

The effects on various tribes and territories will vary. We will address each in turn. OASI provisions are, of course, not relevant to this analysis.

Native American tribes will be affected in the same manner as states. To the extent that they have a tribal tax system, they will likely bring it into conformity with the federal system. Tribes which exist mainly on casino revenue, where members pay no direct taxes, can still benefit from harmonizing with the federal tax reforms we outline here. This is especially the case if an NBRT is adopted with offsets for employers who perform or fund social welfare functions in lieu of payment of taxes.

Our proposal replaces TANF with privately or publicly provided adult education, with participants funded at the minimum wage and receiving the same refundable child tax credit as workers, along with the same health plan as employees of the provider organization. This feature could also be used to replace Tribal TANF, allowing participants to achieve real education rather than job training for low wage work. This is especially the case if program participants can then transition into either technical education or even college – where the employer pays a wage while paying tuition in exchange for both a NBRT credit and a work requirement/student loan.

High income surtaxes may or may not be used, based on tribal debt loads. Use of a VAT will be entirely based on the circumstances of the tribe, although we expect that a federal VAT, which will likely apply to both commerce and gambling, will be used by tribal governments. In addition, because the purchase of gambling tokens will be covered by VAT, winnings need not be, although we expect that the tribal casinos will follow federal policy toward gambling winnings as a whole. To the extent that federal income taxes are owed on gambling winnings for high income earners at non-tribal casinos, they will likely be federally taxable if won from tribal casinos. If a VAT is serious considered, we expect separate hearings on this question of gambling winnings.

Territorial governments, not including the District of Columbia, are not taxed and will therefore be under no obligation to enact tax reform to conform to federal law. As with tribal governments, however, they may enact such reforms as the NBRT in order to harmonize social welfare system delivery with state programs and replace any territorial income tax for non-high earners with the VAT/NBRT proposals outlined in our plan. The District of Columbia government will benefit greatly from a shift from an income tax based system to a consumption tax based system, provided it is treated in the same way as the several states for purposes of payments in lieu of taxes for NBRT revenue that would otherwise be owed to them for federal payroll, especially in regard to payments to neighboring jurisdictions whose employees cross state lines to work.

To not treat the District equally in this regard would give an undue subsidy to the Commonwealth of Virginia and the State of Maryland and would prolong the District's colonial status. Settling this issue in the same way it is settled for all other cross-border workers will remove the thorniest obstacle to statehood for New Columbia (along with first offering Maryland a chance to reclaim territory not retained by the residual District of Columbia – which should only include the Capitol grounds and office buildings where staff members can file state income taxes (and presumably NBRT PILT payments) in the member's home state. The remainder of the federal core should be part of New Columbia, including military bases, so that military members cannot claim the three electoral votes provided for in the 23rd Amendment.

If federal operations are treated as if they were non-profit companies, than VAT would not be paid on them by either the states or the District of Columbia. Commercial operations would, of course, be VAT eligible at the local level for purposes of state, District and federal taxation. High-income taxation will be changed in exactly the same way as any other state which practices fiscal conformity.

Thank you for the opportunity to address the committee. We are, of course, available for direct testimony or to answer questions by members and staff.

DONNA M. CHRISTENSEN
DELEGATE, VIRGIN ISLANDS

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Statement
of the
Honorable Donna M. Christensen
Senate Finance Committee
Hearing on:
"Tax Reform: **What It Could Mean for Tribes and Territories.**"
May 15, 2012

Mr. Chairman, thank you for the opportunity to offer my views on the important subject of today's hearing. Tax Reform will have far reaching effects for those American citizens residing in mirror code jurisdictions such as my Congressional District, the U.S. Virgin Islands, as it will for residents of 50 states.

I view comprehensive tax reform legislation not just as a chance to begin addressing our country's deficit and long-term debt through closing loopholes and adjusting tax rates but also as an opportunity to make changes to our tax code that will spur economic development and growth. In this vein I will briefly outline a series of proposals we have presented to the Finance Committee in the past, to help the Virgin Islands counter many of the economic challenges we currently face including remotes from the U.S. mainland and a lack of natural resources and as of recent weeks, no manufacturing base.

**Elimination of the Cap on Rum Tax Revenues**.

Last month I testified before House Ways and Means Select Revenue Subcommittee on the importance of the rum cover over program to the U.S. Virgin Islands. I pointed out that the cover-over is part of the fundamental tax relationship between the United States and its Territories that goes back over 100 years, before there was even an income tax. When the United States acquired Puerto Rico and the Virgin Islands at the turn of the last century, Congress generally exempted these new Territories — not then destined for Statehood — from the application of the U.S. Internal Revenue laws, including federal excise taxes on manufactured goods.

In order to protect domestic manufacturers from untaxed Territorial manufacturers, however, Congress from the very beginning imposed on products manufactured in Puerto Rico and the Virgin Islands a tax "equal to the internal revenue tax imposed in the United States upon like articles of domestic manufacture."
Thus, the tax imposed on rum manufactured in the Virgin Islands and Puerto Rico and shipped to the United States is not an ordinary excise tax intended to raise revenue for the United States, but rather, as the courts have recognized, an "equalization" tax intended to regulate commerce between the Territories and the United States and to preserve a "level playing field" between Territorial and mainland distillers. Accordingly, Congress, as part of the Organic Acts that govern the relationship between the United States and the Virgin Islands and Puerto Rico, provided that all such equalization taxes be returned, or "covered over," to the treasuries of the respective Territories.

I urged the subcommittee to extend the cover over from it permanent rate of $10.50 to $13.25 because the Virgin Islands Government issues bonds, backed by these rum taxes, to finance construction of schools, hospitals, and other essential public works in the Territory. Any funds not encumbered are used to support general expenses of the Government. In addition to maintaining the Federal-Territorial tax relationship, the cover-over legislation is critical to the Government's efforts to resolve its fiscal crisis. Extension of the rum tax cover-over rate will also help mitigate significant revenue losses associated with the recent decision by HOVENSA to shut its oil refinery on St. Croix, the largest private sector employer in the Territory and one of the 10 largest refineries in the world. Elimination of the cap and the restoration of the cover-over rate to $13.50 per proof gallon as part of tax reform is essential in helping the Virgin Islands recover of the tsunami of economic events it has suffered in recent months.

**Tax Incentives for Long-Term Economic Development**

*H.R. 2220*

As you know Mr. Chairman, long-term economic recovery for the Virgin Islands will require broadening the economic and tax base over time. This I why I sponsored H.R. 2220, the Derek M. Hodge Virgin Islands Improvement Act of 2011 to create a tax-advantaged money-management fund to assist infrastructure development projects in the U.S. Virgin Islands. Under this plan, individual workers would be able to designate a portion of their investment income as part of the Virgin Islands Investment Program. The program is efficient, sustainable, and accountable.

This designation is a one-time event, similar to the process of converting an IRA to a Roth IRA under current law. Upon designation, the funds are accorded Roth treatment, while remaining in their current investment vehicles—no physical transfer occurs and the investment strategy is maintained. Most important, it would allow the Virgin Islands to direct infrastructure development program funding where it is most needed.

Mr. Chairman, the Virgin Island has neither the tax base nor will it receive sufficient federal assistance to make the necessary investments in basic infrastructure like water, sewer, storm-water, roads telecommunications and electric grid. These investments are essential to job creation and providing basic services to the citizens of the Virgin Islands. Additionally, the current infrastructure is not "hardened" against frequent tropic storms, and therefore must be repaired often - further exacerbating the unwillingness of the private sector to invest in basic industries on the islands.

My legislation creates an innovative pilot program to leverage private pension assets to raise revenues for both the federal treasury and investment in the territories. The pilot under this bill would focus specifically on the Virgin Islands but in the future could encompass other territories if successful.

Finally, in May of 2010, the Joint Committee on Taxation estimated the proposal would raise $477 million over 10 years to the U.S. Treasury; however, with the full implementation of the Roth income cap removal, it is now likely to raise approximately $500 million a year.

*Revise Section 936 incentive program*

An important economic incentive was lost during the 1990's when Congress repealed the Section 936 tax credit for U.S. companies that established qualified manufacturing operations in Puerto Rico and the Virgin Islands. The Congressional action was mainly directed at Puerto Rico but no attempted to negotiate a substitute incentive or even a reasonable transition period. I believe an opportunity was lost and would urge you to consider putting in place a new economic incentive program for all the territories where by qualified entities would be allowed to repatriate to the U.S. mainland, without additional taxation, as much

as 50% of the profits on their investments in a U.S. Insular Areas. Such a program would be a boom to all of the Territories many of whose economies are operating at near depression levels currently and long-term economic stability.

**Changes to Jobs Act Residency and Source income Rules**

As you know Mr. Chairman, it is the longstanding policy of the United States to promote the economic development of the U.S. Virgin Islands by granting the Virgin Islands exclusive taxing jurisdiction over its residents and the right, in certain situations, to reduce the income tax liability of such person. Prompted in part by reports of program abuses by persons who neither lived nor worked in the Virgin Islands, Congress included, as part of the American Jobs Creation Act of 2004 ("Jobs Act"), significant changes to the federal tax rules that form the foundation of the Virgin Islands EDC program.

*Residency Rules*

Prior to the Jobs Act, the determination of whether an individual was a bona fide Virgin Islands' resident was based on all of the individual's facts and circumstances. The Jobs Act replaced the "facts and circumstances test" with a new three part residency test. The residency rules issued by the IRS pursuant to the Jobs Act are intended to provide a balance between the interests of the United States in preventing erosion of the U.S. tax base and the interest of the Virgin Islands in ensuring the rights of their citizens to travel freely without losing their possession tax residency. The residency rules now in effect, under the theory that no U.S. citizen should not be able to escape U.S. taxes by claiming to be a bona fide resident of the USVI, would require an individual making such a claim to be present in the territory an average of 183 days.

I support allowing U.S. citizens to satisfy the physical presence test for bona fide V.I. residency by meeting the "substantial presence" test currently applicable to non-resident aliens in the Virgin Islands, such that a bona fide V.I. resident would have to be physically present in the V.I. either 183 days in any one taxable year <u>or</u> an average of at least 122 days a year over any three-year moving average. A taxpayer would also have meet the existing tax home and closer connection tests contained in the Jobs Act. My constituents believe that the current rules are unduly restrictive because various businessmen are required to travel outside the Virgin Islands to attract clients and capital for their businesses.

*Source Income*

Prior to the Jobs Act, the Virgin Islands was authorized to reduce the income tax liability of a bona fide resident of the Virgin Islands with respect to the resident's V.I. source income and income which is effectively connected ("ECI")with the conduct of the resident's V.I. trade or business, regardless of its source. The Treasury never issued regulations defining V.I. source income and V.I. ECI despite authority granted eighteen years ago by the Tax Reform Act of 1986. The Jobs Act provided that the rules for determining U.S. source income generally apply for determining V.I. source income. The Jobs Act also provided that the rules for determining V.I. ECI should be similar to the rules set forth in Code Section 864, which define when income of nonresident aliens and foreign corporations is effectively connected to a U.S. business. The practical effect of the final regulations ha s been to build a wall between the economies of the Virgin Islands and other territories and the economy of the United States.

As a result, I urge you to amend the current law to provide that source income must be materially connected to business activities and assets used in the Virgin Islands and that income attributable to a V.I. office or fixed place of business shall apply in determining whether income is effectively connected with a V.I. trade or business, and thus eligible for Economic Development Commission tax benefits.

Thank you once again Mr. Chairman for allowing me to give my views on tax changes for the U.S. Virgin Islands that I would like to see considered as part of tax reform

**CROW TRIBE OF MONTANA**
**Cedric Black Eagle, Chairman**
**P.O. Box 159**
**Crow Agency, Montana 59022**

**Testimony for**

**United States Senate Committee on Finance**

**HEARING on**

**"Tax Reform: What It Could Mean for Tribes and Territories"**

**May 15, 2012**

## Introduction

Thank you for the opportunity to share the views and concerns of the Crow Nation on Federal tax policy, specifically related to investments in Indian County. Given that the Crow Nation's resources are primarily energy-based, our comments focus on tax provisions that directly impact Indian energy development.

The Crow Nation is a federally-recognized sovereign Tribal government located in southeastern Montana. The Crow Nation occupies a reservation of approximately 2.2 million acres, with abundant natural resources including coal, oil, natural gas, limestone and bentonite. We also are also actively working to develop hydropower and wind power projects utilizing renewable energy resources within our reservation. As such, the Crow Nation is uniquely positioned to contribute to the energy independence of our country.

We believe that existing tax provisions serve to help counter the impact of the many regulatory obstacles facing energy development in Indian Country. We invite this Committee to consider how tax policy can help level the playing field for energy development in Indian Country and help realize the economic value of such resources not only to the Tribes that own them, but to surrounding local communities and the nation as a whole.

Continuing to provide tax incentives to create energy jobs in Indian Country will help overcome other obstacles to energy project development, and will build additional national capacity to create even more jobs in the national economy. This is an opportunity that cannot be missed.

We strongly support permanent extensions of these tax provisions to support longer range infrastructure projects. In any given year, the trio of tax provisions discussed below provides critical benefits to tribal energy projects and tribal governments.

**Energy Opportunities and Obstacles**

Coal

There is an estimated, some believe conservatively so, 9 billion tons of coal held by the Crow Nation. The Absaloka mine outside of Hardin, Montana produces 6 million tons of coal annually; over 175 millions of tons since 1974. The mine annually pays taxes and royalties to the Crow Nation totaling $19 million, which is 60% of our non-Federal budget. The mine provides skilled jobs that pay $16 million; again critical in our economy which struggles with nearly 50% unemployment. As a source of jobs, critical financial support, and US produced energy, it is absolutely critical that it remain open and competitive.

A recent outage at Absaloka's largest coal customer's power plant will hurt jobs and revenues in 2012, and emphasizes the need for multiple energy projects to diversify our revenue sources.

To that end, we have been developing Many Stars, a planned Coal-to-Liquids (CTL) plant. The original plans called for a state of the art clean coal facility capable of producing up to 50,000 barrels or more of liquid products per day ultimately – liquid fuel capable of replacing oil for ultra-clean jet and diesel fuel, which translates to a significant reduction in the need for importing foreign oil, and in turn contributes to national security. It was anticipated that Many Stars, as designed, would create many jobs – up to 2,000 construction jobs and a range of 250 to 900 production jobs dependent on through-put. And with full carbon capture and sequestration, Many Stars seems to be the best way to monetize the Tribe's vast coal resources in the long run while not contributing to the climate change problem.

But uncertainty about national energy policy has made it difficult to attract investment for this cutting edge project. Regulatory uncertainty combined with expiring tax provisions makes future planning quite difficult. Fortunately, technology improvements are making a smaller scale facility possible. We are currently working to bring in a new developer and starting on a smaller scale (8,000 barrels per day), which is now more feasible due to technology improvements

In addition to the Absaloka Mine and the Many Stars CTL project, there is good potential for additional development of very low-sulfur coal on the Reservation that is dependent on rail access to the west coast. This option is burdened by some cost disadvantage and additional BIA regulatory hurdles, as compared to nearby Federal coal.

Oil and Gas

Recent exploration has found natural gas reserves worth developing, but activity has been halted by the markets and the Bureau of Land Management's Application for Permit to Drill (APD) fees of $6500 per well. Off-reservation permit fees compare at less than $100. Limited oil exploration and development is occurring near the western edge of the Reservation.

Wind

Several years-worth of wind data indicates a steady and reliable Class 5/6 wind resource in several areas of the Reservation located in direct proximity to existing transmission lines. Because the wind resource areas encompass lands held in a variety of ownership patterns, including tribal trust, individual tribal member allotments (many of which are highly fractionated), and non-Indian fee lands, developing this resource has proved to be a challenge.

Hydropower

The recent Crow Water Rights Settlement Act of 2010 grants the Nation exclusive rights to develop and market hydropower from the Yellowtail Afterbay Dam. Preliminary planning is underway. To date, the plan is to build a small, low-head hydropower facility with an estimated capacity of 10- Megawatts to supply the local rural cooperatives that provide electric power to the Reservation.

**Leveling the Playing Field for Indian Energy Projects**

Regulatory obstacles

The lease approval and development process is burdensome, slow, and complicated. Regulatory requirements for appraisals and surface access approvals to conduct exploration on Indian trust lands, along with slow environmental assessments, create delays and uncertainties significant enough to make our projects non-competitive. These types of burdens and other limitations in the federal Indian law tend to discourage investments in, and ultimately development of our projects.

Incomplete land records, inadequate BIA staffing, and surface land fractionation add more burdens to energy projects on Reservation lands, in the form of extensive land work, mineral rights research, and hundreds of surface landowner consents.

Effective Federal tax incentives are essential to help offset some of these extra burdens.

Federal Tax Incentives

While the existing federal tax incentives work to encourage investment and development on Indian energy projects and to provide critical support to ongoing tribal energy projects, their usefulness is limited by the length of their applicability. For example, the tax incentives that have worked to keep the Absaloka mine open and competitive since 2006 are due to expire at the end of this year and so cannot be counted upon by investors considering support of mine expansions and other new long-lead-time projects and investments that will take 5 – 10 years to begin producing.

As further explained in the attachment to this testimony, permanent extensions and appropriate modifications to these existing tax incentives would facilitate jobs and economic development, particularly energy development, on the Crow Reservation and for all of Indian Country. We strongly support the Indian Coal Production Tax Credit and the accelerated depreciation provision being made permanent, along with some additional modifications. We also recommend that the Indian Wage Tax Credit be refashioned to mirror the very successful Work Opportunity Tax Credit, which will be a much more effective tool to encourage employment on reservations.

Extension of the Wind Energy Production Tax Credit is also essential to development of Tribal wind resources and ability for the Tribe to make direct use of the credit will provide options for ownership and control. Development of clean coal conversion projects to utilize large Tribal coal resources will also be facilitated by extension of the 50-cents per gallon alternative fuel excise tax credit for a period of 10 years following start-up for those coal-to-liquids (CTL) projects starting construction prior to 2020.

**Conclusion**

Given our vast mineral resources, the Crow Nation can, and should, be self-sufficient. We seek to develop our mineral resources in an economically sound, environmentally responsible and safe manner that is consistent with Crow culture and beliefs.

The Crow people are tired of saying that we are resource rich and cash poor. We respectfully request your assistance in setting the foundation to make our vision a reality.

We have been working to develop our energy resources and to remove obstacles to successful development. We hope to build a near-term future when our own resources, in our own hands, provide for the health, hopes and future of our people.

It is critical that Congress act to protect Indian nations' sovereignty over their natural resources and secure Indian nations as the primary governing entity over their own homelands. This will have numerous benefits for the local communities as well as the federal government.

The Crow Nation has been an ally of the United States all through its history. Today, the Crow Nation desires to develop its vast natural resources not only for itself, but to once again help the United States with a new goal -- achieving energy independence, securing a domestic supply of valuable energy, and reducing its dependence on foreign oil.

However, our vision can only become a reality with Congress' assistance. Mr. Chairman, Mr. Ranking Member, and Committee members, thank you again for the opportunity to provide testimony on how federal tax policy and incentives can help level the playing field for Indian Energy development.

## ATTACHMENT

### Explanation of Proposed Indian Tax-Incentive Amendments

The *Omnibus Budget Reconciliation Act of 1993*, Pub. L. 103-66, 107 Stat. 558-63, codified at 26 U.S.C. 168(j), 38(b), and 45(A) provided for two Indian reservation-based Federal tax incentives designed to increase investment and employment on Indian lands. The theory behind these incentives was that they would act in tandem to encourage private sector investment and economic activity on Indian lands across the United States. Neither incentive is available for gaming-related infrastructure or activities. The incentives --- an accelerated depreciation allowance for "qualified property" placed in service on an Indian reservation and an Indian employment credit to employers who hire "qualified employees" -- expired on December 31, 2003, and have been included in the short-term "extenders packages" of expiring tax incentives since that time.

The Indian Coal Production Tax Credit was enacted in the Energy Tax Incentives Act of 2005 and serves to inoculate tribes that chose to mine their coal resources from the many vagaries of the markets, thereby allowing some stability in productive use of tribal resources for the benefit of these tribal governments and their members.

Permanent extensions of these tax provisions are sought in order to attract long term investment. Although short-term extensions do not provide the kind of certainty to investors when it comes to long-term business planning, the extenders do serve to support the current operations for tribal energy tribes.

**Indian Coal Production Tax Credit**

The Indian Coal Production Tax Credit is very important to the Crow Tribe. The Energy Tax Incentives Act of 2005 provided a business tax credit starting in tax year 2006, based upon the number of tons of Indian coal produced and sold to an unrelated party. 'Indian coal' is coal produced from reserves owned by an Indian Tribe or held in trust by the United States for the benefit of an Indian tribe, as of June 14, 2005, and from facilities that were placed in service before January 1, 2009. The tax credit is calculated by multiplying the number of tons of Indian coal produced and sold by $1.50 for calendar years 2006 through 2010; and by $2.00 for calendar years beginning after 2010. Both dollar amounts will be adjusted for inflation each year. The credit does not apply for sales occurring after December 31, 2012. The purpose of this tax credit was to neutralize the impact of price differentials created by $SO_2$ emissions allowances thereby allowing Indian coal to remain competitive.

The Tribe seeks a permanent extension to the Indian Coal Production Tax Credit, and to allow the credit to be used against alternative minimum tax (AMT) for the full period of the credit, to extend the "placed in service" date (from "by January 1, 2009" to "by January 1, 2025"), and to delete the requirement that the coal be sold to an unrelated person (to allow mine-mouth coal conversion facilities to participate as well as facilities owned by Tribes).

As the original Indian coal production tax credit served to minimize the threat to the Crow Tribe's ability to continue to mine coal at the Absaloka Mine, and thereby continue providing employment and funding critical governmental functions, these amendments to extend the ICPTC now sought by the Crow Tribe will continue to accomplish those critical objects while allowing the Tribe further develop its very large low-sulfur coal resources in Montana.

**Accelerated Depreciation Allowance**

In general, "qualified Indian reservation property" is defined as property 1) used by the Federal taxpayer in the conduct of a trade or business within an Indian reservation, 2) is not used or located outside the reservation on a regular basis, and 3) is not acquired by the taxpayer from a person who is related to the taxpayer. Certain property ("qualified infrastructure property") *may* be eligible for the accelerated depreciation allowance even if located *outside* an Indian reservation if it connects with qualified infrastructure property located within the reservation. Specific examples included in section 168 are "roads, power lines, water systems, railroad spurs, and communications facilities." *See* 26 U.S.C. 168(j)(4)(C).

Depreciation schedules for qualified property are as follows:

| | |
|---|---|
| 3-year property | 2 years |
| 5-year property | 3 years |
| 7-year property | 4 years |
| 10-year property | 6 years |
| 15-year property | 9 years |
| 20-year property | 12 years |
| Nonresidential real property | 22 years |

Because renewable and non-renewable energy activities require significant equipment and physical infrastructure and involve the hiring of large numbers of employees, the Congress has repeatedly recognized that the 1993 incentives are ideally geared to energy development on

Indian lands. Conservative estimates of proven and undeveloped energy reserves on Indian lands suggest that revenues to tribal owners would be in the billions.

As currently written, the depreciation allowance could be interpreted to exclude certain types of energy-related infrastructure related to energy resource production, generation, transportation, transmission, distribution and even carbon sequestration activities. We recommend that language be inserted to clarify congressional intent that this type of physical infrastructure does indeed qualify for the accelerated depreciation provision. In proposing this clarification, it is not our objective to eliminate those non-energy activities that might benefit from the depreciation allowance. Indeed, if adopted, the language we propose would continue to encourage other forms of economic activity on Indian lands.

The current definition of "Indian Reservation" also could be interpreted to exclude facilities such as the Absaloka Mine and future coal development to support coal-conversion facilities. The language we propose would clarify the definition of "Indian Reservation" to include facilities that utilize Tribal or Indian trust minerals that are located outside the Reservation surface boundaries, such as Crow coal in the "ceded strip" immediately north of the Reservation boundary, where the coal itself is held in trust by the United States and considered to be part of the Reservation.

By providing this clarifying language and making the provision permanent, this accelerated depreciation provision will enhance the Crow Tribe's ability to work with the energy industry to develop long-term energy projects using the Tribe's resources to advance our people.

**Indian Employment Wage Credit**

The 1993 Act also included an "Indian employment wage credit" in an amount not to exceed 20 percent of the excess of qualified wages and health insurance costs that an employer pays or incurs. "Qualified employees" are defined as enrolled members of an Indian tribe or the spouse of an enrolled member of an Indian tribe, substantially all of the services performed during the period of employment are performed within an Indian reservation, and the principal place of abode of such employee while performing such services is on or near the reservation in which the services are to be performed. *See* 26 U.S.C. 45(c)(1)(A)-(C). The employee will not be treated as a "qualified employee" if the total amount of compensation to that employee exceeds $35,000 annually.

Our experience in attempting to use this credit to attract private-sector investment in energy projects on our reservation is that it is so complicated and unfamiliar that most private entities

conclude that the cost and effort of calculating the credit outweighs any benefit it may provide. We therefore propose that the wage and health credit be revised along the lines of the much-heralded Work Opportunity Tax Credit, which is less complicated and more likely to be used by the business community. We propose to retain the prohibition contained in the existing wage and health credit against terminating and rehiring an employee and propose to alter the definition of the term "Indian Reservation" to capture legitimate opportunities for employing tribal members who live on their reservations, even though the actual business activity may not be on-reservation. This amendment would allow the Indian Employment Wage Credit to more effectively fulfill the purpose for which it was originally enacted.

**Alternative Fuel Credit for Coal-to-Liquids Projects**

The Crow Tribe's vast coal resources represent an endowment for future generations. However, in order to monetize these resources for the long-term economic benefit of the Tribe and our members, it is essential that federal tax policy provide stable, long-term incentives for the development of clean coal conversion technologies and projects, such as the Many Stars coal-to-liquids project on the Crow Reservation. The 50 cents-per-gallon Alternative Fuel Credit in I.R.C. Section 6426(d) provides such an incentive for coal-derived liquid fuels produced by facilities that capture and sequester at least 75% of their carbon dioxide emissions, but it expired on December 31, 2011. The Crow Tribe strongly supports restoration and extension of this or a similar credit for a period of ten years following start-up of qualified CTL plants that commence construction prior to 2020.

**Wind Energy Production Tax Credit**

The Crow Tribe has identified wind resources on the Crow Reservation that could potentially support several hundred megawatts of electric generating capacity. This large source of renewable energy is an important complement to the Tribe's coal and other fossil fuel resources. The Tribe strongly supports a multi-year extension to the wind energy production tax credit in Section 45(d) of the Internal Revenue Code.

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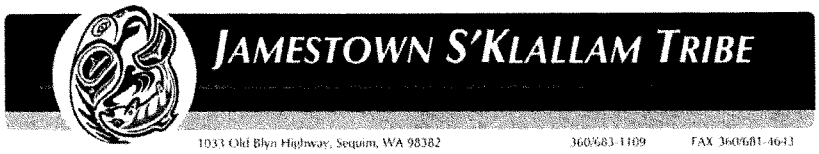


**To the Committee on Finance of the U.S. Senate**
**In connection with its May 15, 2012 hearing on**

**TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES**

**Statement submitted for the Record by Chairman W. Ron Allen**
**Jamestown S'Klallam Tribe**
**1033 Old Blyn Highway**
**Sequim, WA 98382**

**May 29, 2012**

The Jamestown S'Klallam Tribe appreciates this opportunity to submit testimony for the record in connection with the Senate Finance Committee's recent hearing on "Tax Reform: What It Could Mean for Tribes and Territories."

Indian tribal governments have a unique legal status under the U.S. Constitution and numerous federal statutes, court decisions and treaties. Indian tribes are political bodies with a governmental structure. They have the power and responsibility to enact various laws regulating the conduct and affairs of their citizens and trust/reservations lands. Tribes provide a broad range of governmental services to their citizens, including education, transportation, public utilities, health, economic assistance, natural resource management, elder care and social/cultural programs.

The Jamestown S'Klallam Tribe (the "Tribe") is a federally-recognized Indian tribe whose lands are located on the Olympic peninsula in Washington State. "S'Klallam" means "the Strong People." In keeping with its heritage and traditions/culture, the Tribe seeks to be self-sufficient and to provide high-quality governmental programs and services that address the unique social, cultural, natural resource and economic needs of its people. Like many other Indian tribes throughout the United States and unlike most state and local governments, the Tribe does not have a tax base.

Tribes across the United States cannot depend on the federal government to live up to its Treaty obligations and historical promises, so they must develop Tribal businesses to generate revenues to provide the essential services to their citizens. Thus, when an Indian tribal government borrows money to fund infrastructure or major projects, it must demonstrate to lenders that its tribal enterprises will furnish a steady source of revenue to ensure repayment.

Federal tax reform is of great interest to our Tribe and its citizens. There are many ways in which the federal tax system is in need of reform. While Tribal Nations are generally treated as governments and, as such, their undistributed income is not subject to federal tax, they are frequently treated less favorably than state and local governments under our federal Tax Code and by the Internal Revenue Service. Such

federal differential treatment results in Indian tribal governments being denied certain federal tax exemptions and incentives that state and local governments typically enjoy -- such as access to tax-exempt financing. In addition, disproportionate IRS audits have resulted in an actual chilling of the bond market for Indian tribal issuances and in the imposition of a federal toll charge on tribal governmental expenditures for the health, education and welfare of their citizens.

Federal tax reform represents a significant opportunity to provide more consistency in the federal Tax Code with respect to governmental entities--including state, local and tribal governments.

**I. The Senate's Consistent Recognition of the Importance of Tribal Tax Parity**

The Senate Finance Committee has established a consistent track record of working on a bipartisan basis to recognize that Indian tribes should be treated on par with states for federal tax purposes. The Indian Tribal Governmental Tax Status Act was based on legislation introduced in 1981 by Senators Wallop, Bradley, Hatfield, Packwood and Baucus (S. 1298, 97th Cong.). The legislation's goal was to put Indian tribes on par with states for federal tax purposes. While the Indian Tribal Governmental Tribal Tax Status Act (codified in Section 7871 of the Tax Code) fell short of its original intent in several respects, it represented a significant step toward the goal of governmental tax parity.

Since the early 1980s, the Senate has consistently recognized the need to put Indian tribes on par with states--particularly, in the areas of federal unemployment tax, tribal tax-exempt bonds, tribal pension plans, and tribal charities.

- In 2000, many Senators, including several current members of the Finance Committee, supported the inclusion in a House-Senate conference of a provision to treat tribes like states for Federal Unemployment Tax Act (FUTA) purposes. See S. 3152 (Community Renewal and New Markets Act of 2000), introduced by Sen. Roth on October 3, 2000 and co-sponsored by 34 members of the Senate, including Senators Baucus, Conrad, Grassley, Hatch, Kerry, Rockefeller and Schumer). This important legislation was enacted in 2001.

- In 2003 and 2007, several Senators, including Senators Baucus, Campbell, Gordon Smith, Inouye and others introduced or co-sponsored legislation to treat tribes like states for tax exempt bond purposes. See S. 1546 (Tribal Tax-Exempt Fairness Act) (introduced on July 31, 2003) and S. 3567 (Tribal Tax-Exempt Bond Parity Act) (introduced July 24, 2007).

- In 2006, the Senate passed S. 1783, including a provision championed by Senator Gordon Smith to treat pension and employee benefit plans sponsored by tribes the same as state and local governmental plans. Unfortunately, in the House-Senate conference on the Pension Protection Act of 2006, the Senate's provision was significantly modified to apply a different standard for tribal plans.

- Also in 2006, the Senate-passed version of the Tax Administration Good Government Act (H.R. 1528, 108th Cong.) included a provision to treat tribes the same as states with respect to the public charity status of 501(c)(3) organizations formed, funded and/or controlled by tribes. Unfortunately, this bill did not go to conference with the House.

Notwithstanding this long and consistent history, there are many ways in which tribes are not treated as states for federal tax purposes.

## II. Tribal Tax Parity -- Priority Legislative Issues

### *A. Tribal Tax-Exempt Financing*

The Finance Committee's consideration of tribal tax-exempt financing in the context of tax reform is timely. There has been a need to change the tax law applicable to such bonds for many years, but the current economic climate highlights in even greater relief the harsh realities of the financial market and the steep challenges faced by tribes in financing the many worthwhile projects in Indian Country. Now that the Treasury Department's study has acknowledged that current law is lacking in "tax parity, fairness, flexibility and administrability," it is time for Congress to move forward and adopt new rules for tribal bonds. See Department of Treasury, Report and Recommendations to Congress regarding Tribal Economic Development Bond Provision under Section 7871 of the Internal Revenue Code (December 19, 2011). Senator Baucus, in his remarks at the hearing on May 15, 2012, recognized the need for change in this area when he stated that "Congress should...level the playing field for tax-exempt bonds."

There are several key components to legislation that would effectively level the playing field for tribal tax exempt bonds, including:

- Eliminating the essential governmental function test for tribal governmental bonds
- Avoiding the imposition of other unworkable restrictions, such as a territorial limitation on tribal bond financed facilities
- Repealing the prohibition on private activity bonds and substituting a workable volume limitation procedure
- Providing tribal governments the same exemption from registration and disclosure rules currently provided to states in Section 3(a)(2) of the Securities Act.

We firmly believe that the lack of a tribal tax base may justify other measures to remove the barriers to federal guarantees of certain types of tax-exempt debt issued by Indian tribal governments. These political measures will significantly enhance Indian tribes' ability to generate alternative revenue sources to provide for critically needed services to their communities and citizens.

**1. Eliminating the Essential Governmental Function Test**

Under current law (other than through the special provision for tribal economic development bonds contained in the American Recovery and Reinvestment Act), Indian tribal governments are allowed to issue tax-exempt bonds only to finance facilities that serve an "essential governmental function." While neither the statute nor any IRS regulation defines what constitutes an "essential governmental function," the legislative history describes the test in terms of activities "customarily performed by State and local governments with general taxing powers." It is frequently very difficult to determine—with the certainty that a tax-exempt debt offering requires--whether particular activities are "customarily performed" by states and municipalities. While it is clear that Indian tribes may finance roads, schools and sewers, the essential governmental function test has become troublesome when applied to many other areas in which state and local governments have become increasingly active – *e.g.*, convention centers, tourist accommodations and public recreational facilities including golf courses, energy production and distribution facilities, parking and transportation—just to name a few. Moreover, because the standard is both fact-specific and open to IRS interpretation, the chances of inequitable and uneven treatment increase dramatically.

By contrast, the standard generally applicable to state and local government bonds (the "state/local government standard") has proven to be a workable one. It is met if either 90 percent or more of bond proceeds are used for governmental use (the "private business use" test), or 90 percent or more of debt service is payable or secured from governmental payments or property (the "private payment" test). While there will undoubtedly be interpretive issues with respect to what constitutes a governmental use, and what constitutes a governmental payment, we believe that these issues will be much easier to work out and apply to the Indian tribal government context than the essential governmental function test. Thus, the state/local government bond standard should be extended to include Indian tribal government bond financings.

In sum, replacing the essential governmental function test with the state/local government standard has at least three advantages: (1) the state/local government standard is more administrable than the essential governmental function test, (2) as a policy matter, Indian tribal governments should not be treated differently than state and local governments, and (3) the private business use test (or, alternatively the private payment test) should be sufficient for ensuring that tax-exempt bond proceeds are used appropriately.

**2. Avoiding the Imposition of Other Unworkable Restrictions**

While the Treasury Department has agreed that the essential governmental function test is unworkable and should be repealed, it continues to recommend that Congress consider enacting some kind of territorial or locational restriction on tribal tax-exempt financing. Like the pilot provision in ARRA limiting the use of Tribal Economic Development Bonds (TEDBs) to projects located on Indian reservations, a tax proposal in the Obama Administration budget for FY 2013 would require that tribal bond-financed projects be located on or near Indian reservations. See Treasury Department, General

Explanation of the Administration's Revenue Proposals (released February 2012), p. 51 (http://www.treasury.gov/resource-center/tax-policy/Pages/general_explanation.aspx). Under the Administration's tribal bond proposal, projects located "near" as opposed to "on" a reservation would be required to "provide goods or services to resident populations of Indian reservations." It should be noted that no similar locational restriction applies to state or local government bonds, while private activity bonds merely need to demonstrate a "nexus" or "substantial connection" to the jurisdiction of the bond issuer.

The territorial limitation in ARRA would, if extended to a broader range of tribal bonds, cause numerous practical problems. Many Indian tribes do not have much land, particularly land which has been accepted into trust by the United States. Other tribes may have ample reservation or trust land, but their locations are frequently so remote that no revenue-generating facilities can be placed there. The land also may not be in a location where significant community services, such as health care or education, can be rendered to the tribe's citizens. The proposed territorial limitation places these tribes at a serious disadvantage.

In light of these facts, we strongly recommend that any future legislation contain no territorial restriction whatsoever as long as the proceeds are not for private use (*i.e.*, no territorial restriction on tribal government bonds). We also think that a flexible standard should apply to tribally-issued private activity bonds. If Congress believes a territorial restriction is necessary, it should allow tribes to finance projects that have a "substantial connection" or an appropriate "nexus" to a Tribe's reservation, using a definition for the term "reservation" that is no more restrictive than the one found in Code Section 168(j) (Accelerated Depreciation).

The "substantial connection" or "nexus" test is illustrated in Private Letter Ruling 8442023 (July 12, 1984). In this ruling, the IRS permitted an industrial development authority to finance a hotel approximately 10 miles outside its jurisdictional boundaries because the issuer was able to show that there would be a direct, material benefit to the issuing jurisdiction. This approach would provide Indian tribes with the flexibility to finance nearby projects that directly benefit the Tribe as a whole. Further, the "substantial connection" or "nexus" test applies to state and local governments, and Indian tribal governments should be accorded the same treatment.

Another potentially unworkable restriction concerns the use of bonds for gaming facilities. While we would urge Congress not to impose such a restriction (particularly with respect to Indian tribal gaming facilities that are both owned and operated by the tribe), we also understand that permitting tax-exempt financing of gaming facilities is a political issue. If Congress is unwilling to lift this restriction in its broader revision of the rules governing tribal bond issuances, we request the adopt a more flexible approach to the use of tax-exempt financing for hotel, convention and other facilities that are ancillary to a gaming facility.

The approach taken by the IRS in the TEDB guidance is too restrictive. In IRS Notice 2009-51, the IRS required Indian tribal governments seeking an allocation of bond issuing authority to certify that

> *no portion of the proceeds of any Tribal Economic Development Bonds issued pursuant to the requested application will be used to finance any portion of a building in which class II or class III gaming, as defined in section 4 of the Indian Gaming Regulatory Act, is conducted or housed, or any other property actually used in the conduct of such gaming.*

To be certain of compliance, a tribal applicant must avail itself of an IRS safe harbor, which is described IRS Notice 2009-51 as follows:

> *As a safe harbor, a structure will be treated as a separate building if it has an independent foundation, independent outer walls and an independent roof. Connections (e.g., doorways, covered walkways or other enclosed common area connections) between two adjacent independent walls of separate buildings may be disregarded as long as such connections do not affect the structural independence of either wall.*

This safe harbor has given rise to significant confusion in practice. In formulating workable standards, Congress should clarify that tax-exempt financing is allowed for projects, such as convention centers and hotels, built adjacent to and even integrated in with tribal casinos. This lack of clarity has had a chilling effect on Tribal development projects and is likely to result in the adoption of architectural designs which are aesthetically and functionally inferior.

### 3. Repealing the Prohibition on Private Activity Bonds

The revenue proposal contained in the FY 2013 Administration Budget would allow Indian tribal governments to issue tax-exempt private activity bonds for the same types of projects and activities as are allowed for State and local governments under Section 141(e) under a national bond volume cap. In addition, the same volume cap exceptions applicable to State and local governments would apply to the tribal tax-exempt bonds. However, unlike state and local private activity bonds, tribal private activity bonds (like all tribal bonds) would be subject to a territorial or project location restriction and a gambling facility restriction.

As noted above, the Treasury proposal would employ a national bond volume cap for Indian tribal governments, which it describes as comparable to that applicable to states, but also "tailored" to the tribal context:

This tailored national Tribal private activity bond volume cap for all Indian tribal governments together as a group would be in an amount equal to the greater of:

> (i) a total national Indian tribal population-based measure determined under Section 146(d)(1)(A) (applied by using such national Indian tribal population in

lieu of State population) *[$190,000,000 based on an assumed Indian tribal population of 2,000,0000 nationwide],* or

(ii) the minimum small population-based State amount under Section 146(d)(1)(B) *[$284,560,000 in 2012].*[1]

The Treasury proposal would delegate to the Treasury Department the responsibility to allocate this national bond volume cap among Indian tribal governments.

Allocation schemes have not worked well for Indian Country bond financings. For example, Congress provided an allocation scheme for state, local and tribal governments to issue Clean Renewable Energy Bonds (CREBs), but no tribal governments received CREBs allocations. Congress also provided an allocation scheme for TEDBs, and while the national volume cap of $2 billion was fully allocated among over 75 tribes in two tranches, we understand that only 5% of this amount had been issued by the expiration date, and now the remaining 95% is going to have to be re-allocated. Many tribes applied for allocations with little or no readiness to issue debt, while others were not able to use their allocation because it was too small and did not cover the cost of the project to be financed.

If tribal private activity bonds are subject to a locational restriction and a gambling facility restriction, they should not also be subject to a national volume cap that must be allocated among the over 500 tribal government issuers.

**B. Tribal pension and employee benefit plans**

If the "essential governmental test" is unworkable in the government bond context, it is proving to be even more unworkable in the tribal employer plan arena.

Under a provision negotiated by a House-Senate Conference on the Pension Protection Act of 2006, tribal governmental plans are not treated as "governmental plans" unless all of the employees in the plan are substantially engaged in "essential governmental" functions, and not commercial activities. While the legislative history of the provision suggests that Congress intended to exclude casino, hotel, service station, casino and marina employees from being covered by a governmental plan (if the employer is a tribal government), it did not give much guidance on how the test would apply in other contexts.

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[1] According to the US Census website (http://quickfacts.census.gov/qfd/states/00000.html), there are an estimated 2,804,327 self-identifying American Indian/Alaska Native individuals in the US as of 2011. This number reflects people who self-identify as AI/AN, not the number of enrolled members. By contrast, in the BIA's 2005 American Indian Population and Labor Force Report, the latest available, the total number of enrolled members of the (then) 561 federally recognized tribes was shown to be 1,978,099. See http://www.bia.gov/cs/groups/public/documents/text/idc-001719.pdf. Given the 7 years that have passed since that BIA report was issued (including changes in the number of federally recognized tribes), it is unclear whether this number remains accurate.

Consequently, tribal government employers have been hamstrung in their efforts to maintain governmental plans, and economically coerced to adopt private employer plans. Because of the typical mix of tribal governmental and economic development functions, the 2006 provision is uniquely ill-suited to the needs of tribal government employers. We also suspect that if the test applied to present-day state government workforces, they would find it equally unworkable.

The Senate-passed version of the 2006 pension legislation (S. 1783, 109th Cong.), which had strong bipartisan support from members of this Committee, contained a much more administrable and equitable approach to the treatment of tribal governmental plans. Such language is reproduced below as follows.

> **SEC. 1311. DEFINITION OF GOVERNMENTAL PLAN.**
>
> (a) Amendment to Internal Revenue Code of 1986- Section 414(d) of the Internal Revenue Code of 1986 (definition of governmental plan) is amended by adding at the end the following: `The term `governmental plan' includes a plan established or maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency instrumentality (or subdivision) of an Indian tribal government, or an entity established under Federal, State, or tribal law which is wholly owned or controlled by any of the foregoing.'.
> (b) Amendment to Employee Retirement Income Security Act of 1974- Section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)) is amended by adding at the end the following: `The term `governmental plan' includes a plan established or maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency instrumentality (or subdivision) of an Indian tribal government, or an entity established under Federal, State, or tribal law that is wholly owned or controlled by any of the foregoing.

Congress should adopt similar language to eliminate the dysfunctional complexity of present law and to put tribal governmental plans on par with state and local plans.

## III. Specific Instances Where IRS Audits Have Targeted Tribal Governments

### A. Tribal Bond Audits

The Finance Committee has already heard testimony in previous committee hearings--in 2006 and 2008--regarding the disproportionate number of IRS audits focused on tribal governmental bond offerings. The large number of tribal bond audits conducted by the IRS between 2002 and 2007, together with the restrictive approach taken by the IRS in these audits, has had the undeniable effect of chilling the market for tribal bonds at a time when credit was otherwise available for government projects.

**B. Recent IRS Audits Focused on General Welfare Programs of Tribal Governments**

More recently, IRS audits have focused on the social welfare programs of tribal governments. Starting in approximately 2004, the IRS began a special audit focus on tribal government programs providing in-kind benefits to tribal members. As a result of that initiative, the IRS began focusing on tribal government programs, including the following:

- Health Care Programs
- Educational Programs
- Housing Programs (including preparation of reservation home sites for building, housing improvement, construction, down payment assistance, and maintenance/repairs)
- Loan Programs
- Emergency Assistance
- Cultural Events and Community Activities (e.g., powwows)
- Cultural Travel
- Elder Programs (including meals, social events and utility assistance)
- Legal Aid
- Recreation and sporting events
- Landscaping and grounds maintenance

The underlying assumption behind these IRS examinations is that Indian tribal governments are distributing taxable income (whether in cash or in kind) to or on behalf of tribal members. Furthermore, the IRS is auditing the tribal governments based on the legal premise that they (as payors) have obligations to report such payments to the IRS (and the payees) by issuing 1099s. In certain cases, the IRS has also contended that the in-kind benefits represent deemed per capita payments of gaming revenues, and thus the tribal government must withhold tax on such payments under Section 3402(r).

In testimony at a September 18, 2009 hearing before the Senate Committee on Indian Affairs on the IRS treatment of tribal government health programs, Sarah Hall Ingram, the current IRS Commissioner for Tax Exempt and Governmental Entities, denied that the agency was targeting Indian tribal governments or that it had any special program to examine tribal health programs. Rather, Commissioner Ingram contended that "the issue of the taxability of medical benefits and health insurance coverage can arise from time to time in the normal course of an audit as we look at whether a tribe, or any other type of government or employer, is following appropriate information reporting and withholding practices as it administers its various programs."

More recently, on November 15, 2011, the IRS announced that it would be reexamining the applicability of the general welfare exclusion as applied to tribal government

programs. Indian tribes have been asked to submit written comments to the IRS describing their programs, particularly the following.

- **Cultural** (for example, programs involving tours of sites that are historically significant to a tribe; language preservation programs; community recreational programs; cultural and social events);
- **Education** (for example, programs providing tutors or supplies to primary and secondary school students; job retraining programs for adults);
- **Elder programs** (for example, programs providing heating assistance or meals); and
- **Housing** (for example, programs providing housing on and off the reservation, with income limits different from those of the United States Department of Housing and Urban Development).

See IRS Notice 2011-94 at http://www.irs.gov/pub/irs-drop/n-11-94.pdf.

As a result of this recent administrative focus, many tribal leaders are concerned that IRS audits of tribal programs may increase, along with potential tax withholding and reporting liabilities imposed on tribal governments. Tribal leaders and their representatives also take issue with the IRS' attempt to characterize these programs as involving deemed per capita distributions, citing the inconsistency between the IRS' overly definition of a per capita payment and the Department of Interior's approach in regulations and other guidance promulgated under the Indian Gaming Regulatory Act. See 25 C.F.R. § 290.2 (distinguishing between per capita and social welfare payments).

Recent IRS actions in auditing tribal governments on their social welfare and other governmental programs are clearly not comparable to IRS' current or historical treatment of state and local governments. There is no evidence that any similar audit initiative exists for state and local government programs. The tribal governmental audits should be suspended--at least until such time as the IRS has articulated the relevant legal standards that apply to tribal government programs. The Jamestown S'Klallam Tribe is especially concerned about the IRS focus on educational and cultural programs.

**Conclusion**

Tax reform affords Congress an opportunity to re-fashion the Tax Code so it is simpler and fairer. Tribal governments have long been subjected to tax laws that are neither simple nor fair. By consistently treating tribes like states (and eliminating the special rules that are so unworkable), Congress can go a long way toward tax reform with respect to tribal governments. In addition, Congress needs to exercise oversight over the IRS to ensure that its administration of the Tax Code (including through IRS examinations) is equitable and appropriate. Such reforms--whether achieved through statutory changes or legislative oversight-- will empower Tribal governments to progressively advance their self-governance and self-reliance goals to relieve the historical dependency of Indian communities on federal resources.

**MANDAN, HIDATSA & ARIKARA NATION**
**Three Affiliated Tribes * Fort Berthold Indian Reservation**
Tribal Business Council

**Tex "Red Tipped Arrow" Hall**
**Office of the Chairman**

**Testimony of the Honorable Tex G. Hall**
**Chairman, Mandan, Hidatsa and Arikara Nation of the Fort Berthold Reservation**

**Oversight Hearing on**
**Tax Reform: What It Could Mean for Tribes and Territories**
**Committee on Finance**
**United States Senate**

**May 29, 2012**

Good afternoon Chairman Baucus, Ranking Member Hatch and Members of the Committee. My name is Tex Hall. I am the Chairman of the Mandan, Hidatsa and Arikara Nation (MHA Nation). Thank you for the opportunity to testify on reforming United States tax policies to promote economic development in Indian Country. Despite all the challenges we face, there is no greater impediment to Indian economic development than current United States tax policies.

## Introduction

The MHA Nation and the Fort Berthold Reservation are in the middle of the most active oil and gas play in the United States. The Fort Berthold Reservation is located in the heart of the Bakken Formation, which is the largest continuous oil accumulation in the lower 48 states. In 2008, the United States Geological Survey estimated that the Bakken Formation contains between 3 billion and 4.3 billion barrels of oil.

In the last four years, energy development in and around the Reservation exploded. Despite this explosion, we are still struggling with the federal bureaucracy for every single oil and gas permit. We now have about 250 wells in production on the Reservation and the MHA Nation and Fort Berthold Allottees have earned about $182 million in oil and gas royalties. In addition, we have 905 vendors providing services directly to the oil and gas industry. Each of those vendors employs between 4 and 24 people. Based on an average employment of 12 jobs per company, that is in excess of 10,000 jobs.

In 2012, we expect more wells to be drilled on the Reservation than were drilled in the first four years combined. In 2013, we expect another 300 wells to be drilled. This energy development will result in hundreds of millions in royalty payments and economic activity and provide the MHA Nation with a substantial opportunity to fund government operations, and ensure that our members can heat their homes and provide for their families.

MHA Nation is actively promoting the development of our energy resources and seeking every opportunity to be an active developer of our resources, not just a passive lessor. However, the MHA Nation continues to work on many of the same barriers to Indian energy development that we started working on four years ago. The agencies and the issues change, but we are still trying to overcome outdated laws and regulations, bureaucratic regulatory and permitting processes, and insufficient federal staffing or expertise to implement those processes.

Despite all of these challenges, there is no greater impediment to successful energy and economic development on our Reservation than current United States tax policy.

**Need for Exclusive Tax Authority**

In order to promote energy and economic development on the Reservation, the MHA Nation was forced into an inequitable tax agreement with the State of North Dakota. This tax agreement was required because United States tax policy and federal case law allows states to tax activities on Indian lands. Without this tax agreement, energy companies on our lands would be subject to development-killing dual-taxation.

The tax agreement we were forced into in order to promote economic development on our Reservation is a windfall for the State. About four years after this tax agreement was originally executed, the State has realized billions in budget surplus while the MHA Nation struggles to make ends meet. In 2011 the State collected $1.9 billion in oil and gas tax revenue and this year alone is expected to collect well over $2 billion in oil and gas taxes from western North Dakota.

The MHA Nation and tribes everywhere need Congress to affirm the exclusive authority of tribes to raise tax revenues on our Reservations so that we can rely on the same revenues that governments use to maintain infrastructure and support economic activity. Just like other governments, the MHA Nation needs to maintain roads so that heavy equipment can reach drilling locations, but also so that our tribal members can safely get to school or work. We also need to provide increased law enforcement to protect tribal members and the growing population of oil workers. Additionally, we need to develop tribal codes and employ tribal staff to regulate activities on the Reservation.

Without the revenues provided by exclusive taxing authority, the Reservation bears all of the impacts of energy development and enjoys only a part of the benefit. Meanwhile, our governmental and community infrastructure is almost at a breaking point. I have attached to my testimony three pictures of the tremendous toll energy development is taking on our Reservation roads.

Under our agreement, the State has received about 65 percent of the revenues and the MHA Nation has received about 35 percent through April 2012. However, the majority of tax revenue currently collected under the agreement comes from land held in trust for the MHA Nation or its members. This means that the MHA Nation is absorbing a tremendous amount of the impacts from oil and gas activity both on and off the Reservation with little of the benefit.

The tax revenue that we are receiving under the agreement is not nearly enough to repair and maintain our roads and infrastructure while the boom continues.

For example, the State recently appropriated $1.2 billion for its infrastructure needs in the western North Dakota oil fields; however, little of this will benefit the MHA Nation. For example, none of the state revenue can be used to repair BIA and tribal roads on trust land where the majority of the oil and gas related destruction is ongoing. In addition, four of our communities on the Reservation are not considered townships and are therefore not eligible for any of the state tax revenue even though this revenue is produced in their own back yards.

At the same time, the State socks away 30% of all oil and gas revenues collected into a "Legacy Fund." This is a big savings account that is inaccessible to and will not directly benefit the MHA Nation even though a significant amount of the tax revenue that goes into this savings account comes from production on our Reservation trust land. Our tax revenues should not be going to a State savings account while our trust lands and infrastructure are being destroyed by the oil and gas boom.

I actually agree with an important point the Governor of North Dakota recently made. He said, "The number one priority is to keep up with infrastructure ... growth cannot continue if we do not keep up with all of the impact that happens on communities out there." Unfortunately, this does not appear to include tribal communities, like mine.

In 2011, the State collected more than $75 million in taxes from energy development on the Reservation, but spent less than $2 million of that amount on state roads on the Reservation and zero tax dollars on tribal and BIA roads. Moreover, none of the funds were used to mitigate the other negative impacts that oil and gas development has had on the Tribe and its members. In 2012, projections are that the State will make more than $100 million in oil and gas tax revenues from Reservation oil and gas development; and, given our current tax agreement, we have no reason to believe that the State will spend any of those dollars on our tribal and BIA roads or put any of this revenue back into our communities on trust land.

Chairman Baucus, you hit the nail on the head. In your opening statement you said that "tax reform needs to simplify the code in a way that creates jobs and encourages growth." I can think of no action more simple than affirming the exclusive authority of tribes to tax activities on Indian lands. Current law is unnecessarily too complicated. Current law allows for multiple governments to tax activities on our lands and creates yet another confusing jurisdictional patchwork of laws in Indian Country.

You also said that "Indian governments ... are in some ways similar to state governments; each provides hospitals, public schools and law enforcement." In fact, we do all that and more. As explained above, we provide the infrastructure that economic development relies upon. This includes developing the tribal codes and governing infrastructure that will protect our Reservation homelands. Without tax resources to invest in our communities and provide these protections, energy and economic development on Indian lands will always result in resources being extracted from Indian hands with few or short-lived benefits in return.

In your tax reform efforts, the MHA Nation asks that you develop legislation to affirm the exclusive authority of Indian tribes to tax activities on Indian lands. This legislation would clarify federal case law that has allowed unlimited dual state and tribal taxation on Indian lands without any regard to the chilling effect such a burden puts on Reservation economic development. We have no objection to the State collecting sufficient dollars to cover its actual costs, but it should not be allowed to make a windfall at the expense of the MHA Nation, or any other tribe, from tribal and individual trust lands. For example, legislation could require tribes to fairly reimburse states for any substantiated services that have a nexus to oil and gas production impacts on Indian lands.

**Conclusion**

Thank you Chairman Baucus, Ranking Member Hatch and Members of the Committee for the opportunity to provide this testimony on the most significant barrier tribes face to energy and economic development. Until we fix this problem, the energy and economic development that occurs on Indian lands will be sporadic and will not address the wide-spread poverty and unemployment in Indian Country. It will either occur with limited resources at a snail's pace, or it will be a boom of activity that leaves Reservations stripped of their resources and little long-term investment. Only exclusive tribal authority to tax on Indian lands will provide us the community and governmental infrastructure necessary to promote sustained economic development in Indian Country.

**Photo of Oil and Gas Impacts on Fort Berthold Reservation Roads**

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**Photo of Oil and Gas Impacts on Fort Berthold Reservation Roads**

STATEMENT OF NATIONAL CONGRESS OF AMERICAN INDIANS
TO THE COMMITTEE ON FINANCE
UNITED STATES SENATE

IN CONNECTION WITH THE HEARING ON
"TAX REFORM: WHAT IT COULD MEAN FOR TRIBES AND TERRITORIES"
May 15, 2012

Submitted by the Honorable Jefferson W. Keel
President
National Congress of American Indians
1516 P Street, N.W.
Washington, DC 20036

The National Congress of American Indians (NCAI) appreciates the opportunity to submit this testimony in connection with the Finance Committee's hearing on "Tax Reform: What It Could Means for Tribes and Territories."

Indian tribal governments have a unique status in our federal system under the U.S. Constitution and numerous federal laws, treaties and federal court decisions. Indian tribes have a governmental structure, and have the power and responsibility to enact civil and criminal laws regulating the conduct and affairs of their members and reservations. Tribes operate and fund courts of law, police forces, and fire departments. Tribes provide a broad range of governmental services to their citizens, including education, transportation, public utilities, health, economic assistance, and domestic and social programs. Like the income of states and local governments, tribal revenues are not treated as taxable income – but as the governmental revenues of a distinct sovereign.

Federal tax reform is of great interest to NCAI and its members. There are many ways in which the federal tax system is in need of reform. While tribal nations are governments, they are frequently treated less favorably than state and local governments under our federal Tax Code and by the Internal Revenue Service. Such differential treatment typically results in tribal governments being denied federal tax exemptions and economic development incentives that state and local governments enjoy. In some cases, it enables the federal government to impose what amounts to an inequitable toll charge on tribal governmental expenditures for the health, education and welfare of their own citizens.

NCAI appreciates that the Finance Committee and its members have consistently recognized the governmental status of Indian tribes. Both Senator Baucus and Senator Hatch have been leaders in seeking Tax Code parity for tribal governments. It is critical that members of Congress clearly understand both the unique problems of Indian Country and the governmental status of Indian tribes before restructuring the Tax Code. Thus, in expressing our views on what tax reform "could mean" for Indian tribes, we do so as partners in American growth and, like each of you, as elected governmental representatives of Native American people.

**Tribal Tax Parity--A History of Uneven Progress**

While there is no federal statutory provision that "exempts" Indian tribes from federal income tax, the IRS has consistently and correctly concluded that federally recognized tribes and their federally chartered corporations are not subject to federal income taxes.[1] With respect to tribal governments, the IRS in Revenue Ruling 67-284 based its conclusion on the fact that tribes (like states) are political bodies not subject to the income tax provisions of the Internal Revenue Code (the "Code"). However, the IRS did not treat Indian tribes like states for all purposes of the Code. Revenue Ruling 68-231 provided that tribal bonds could not be treated like state government-issued bonds because Code section 103, which exempts interest paid on state and local bonds from income taxation, did not specifically mention Indian tribes. The IRS took a similar approach to several other Code provisions that explicitly exempted state and local governments.

Recognizing that tribal governments should be treated on par with state governments, Congress passed the **Indian Tribal Governmental Tax Status Act** in 1982 to provide comparable governmental tax treatment to tribes for federal tax purposes.[2] The Tribal Governmental Tax Status Act, codified as section 7871 of the Code, provides that federally recognized tribes are treated like states with respect to the following:

- Deductibility of charitable contributions to governments for exclusively public purposes
- Deductibility of gifts and bequests for public purposes
- Exclusion of interest on tax-exempt bonds (subject to restrictions on tribal bonds discussed below)
- Exemption from certain federal excise taxes (subject to restrictions)
- Deductibility of taxes paid to tribal governments
- Private foundation excise tax rules referencing governments
- Provisions relating to accident & health plans under Section 105
- Provisions authorizing retirement plans under Section 403(b) for educational employees

Although Code Section 7871 did not codify the basic tax immunity of tribal governments, the legislative history indicates that Congress was aware of the IRS's position in Revenue Ruling 67-284 and did not wish to alter it.

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[1] Four revenue rulings address the tax status of tribal governments: Rev. Rul. 67-284, 1967-2 C.B. 55; Rev. Rul. 81-295, 1981-2 C.B. 15; Rev. Rul. 94-16, 1994-1 C.B. 19; and Rev. Rul. 94-65, 1994-2 C.B. 14.

[2] Title II of Pub. L. No. 100-203, 96 Stat. 2605 (1982).

Unfortunately, the Tribal Governmental Tax Status Act did not live up to its original promise of treating tribes on par with states for federal tax purposes. For example, the provision that allowed Indian tribes to issue tax-exempt bonds was subject to many restrictions in the original 1982 Act, and more were added in 1987. Thus, Indian tribal bonds were subject to the following restrictions:

- An absolute prohibition on the issuance of private activity bonds, except for certain tribal manufacturing bonds subject to wage and employment tests that are virtually impossible for modern manufacturing facilities to meet

- Government bonds issued by tribes were required to meet the essential governmental function test (which was considered to be met only when (the project does not generate revenue?)substantially all of the proceeds were used in the exercise of an essential governmental function)

- "Essential governmental functions" for this purpose were limited to those functions "customarily performed" by state and local governments with general taxing powers (e.g., schools, roads and sewers)

The Tribal Tax Status Act also applied the "essential governmental function" test to the excise taxes from which tribes were exempted, even though state and local government exemptions were not so restricted.

In addition to imposing specific restrictions on tribes that were not applicable to states, Section 7871 failed to address many areas of the Code where special treatment is extended to states. Subsequently, the IRS took the position that these omissions demonstrated that tribes should not be treated like states, and denied governmental status with respect to a number of different provisions, including various federal excise taxes not covered by Section 7871. See, e.g., Revenue Ruling 94-81, 1994-2 C.B. 412 ("Indian tribal governments have no inherent exemption from federal excise taxes").

**NCAI Priority--Tribal Tax Parity**

NCAI believes that because Indian Tribes are governments, they should generally be treated like states for all federal tax purposes. As part of a comprehensive tax reform bill, Section 7871 needs to be broadened to treat Indian tribes like states for all tax Code purposes, except in those limited instances where a special rule for tribal governments is absolutely necessary. In most cases, a special rule will not be necessary.

A special rule may be needed so tribes can continue to offer 401(k) retirement savings plans. Since Congress amended the Code in 1995 to specifically clarify that tribes, unlike state and local governments, could offer 401(k) plans, many tribes have adopted 401(k) plans as the primary vehicle for their employees. Many would now like to supplement such plans with governmental pension plans, and corrective legislation is needed to accomplish that goal. But Congress should preserve the right of tribal employers to continue to sponsor 401(k) plans as well.

**Specific Instances where the Tribal Tax Parity is Urgently Needed**

While NCAI believes that Tribes should be treated like states for all tax purposes (and generally should not be subject to special rules or restrictions that states and local governments do not have to meet), there are several specific areas where tribal tax parity is urgently and particularly needed:

- Tax Exempt Bonds (including private activity bonds)
- Employee Benefit and Pension Plans
- Tribally Funded and Controlled Charities
- Treatment as States for purposes of federal streamlined sales tax legislation

Treating tribes like states in these four areas would be a significant step forward, and should be taken in the context of comprehensive tax reform.

**Tribal issuance of tax exempt bonds**

A provision championed by this Committee in the American Recovery and Reinvestment Act (ARRA) authorized $2 billion in bond authority for a new category of bonds for Indian tribes, known as "Tribal Economic Development ("TED") Bonds." Such TED Bonds were intended to provide tribes with more flexibility to use tax-exempt financing than is allowable under the current "essential governmental function" standards as noted above. The TED rules are still subject to other restrictions that require financed projects to be located on Indian reservations and that prohibit the financing of gaming facilities.

The ARRA provision also required Treasury to do a study of the effects of the new bonding authority, and to recommend to Congress whether it should "eliminate or otherwise modify" the essential governmental function standard for Indian tribal bond financing. That Treasury study is now complete and was delivered to the Chairman and Ranking member of this Committee on December 19, 2011.

The core recommendation of the Treasury study is that Congress should adopt the same standard for tribal government bonds as applies to governmental bonds issued by State and local governments. In other words, the Treasury Department recommends repealing the "essential governmental function" standard for Indian tribal governmental bond financing. The Treasury study explains that it is making this recommendation "[f]or reasons of tax parity, fairness, flexibility, and administrability...."

Treasury also recommends that Congress adopt what it calls a "comparable" private activity bond standard so that Indian tribal governments could issue some private activity bonds. Such bonds would be subject to a national volume cap, and Treasury would be authorized to make allocations among Indian tribal governments.

Treasury has further recommended that Congress limit Indian tribal bond issuances in two respects: (1) No bonds could be used for gaming projects, and (2) some kind of project location restriction would apply. With respect to the latter, Treasury has recommended that Congress provide more flexibility than it did for the TED Bonds under ARRA. Specifically, Treasury recommends that tribal bonds be allowed to finance projects that are located on Indian reservations, together with projects that both: (1) are contiguous to, within reasonable proximity of, or have a substantial connection to an Indian reservation; and (2) provide goods or services to resident populations of Indian reservations.

NCAI appreciates the analysis and core recommendations in the Treasury study, but has concerns about the "project location restriction"--even in its modified form. In particular, the requirement that the financed project provide "goods or services" to reservation residents would effectively kill the chances of using tax-exempt debt for many tribal economic development projects. The requirement for proximity to an Indian reservation would also eliminate a tribe's ability to meet state-wide government contracting requirements. It is NCAI's view that tribal governmental bonds--as distinguished from private activity bonds--should not be subject to a "project location" restriction of any type.

**Tribal pension and employee benefit plans**

If the "essential governmental test" is unworkable in the government bond context, it is proving to be even more unworkable in the tribal employer plan arena.

Under a provision hastily conceived in a House-Senate Conference on the Pension Protection Act of 2006, tribal governmental plans are not treated as "governmental plans" unless all of the employees in the plan are substantially engaged in "essential governmental" functions, and not commercial activities. While the legislative history of the provision suggests that Congress intended to exclude casino, hotel, service station, casino and marina employees from being covered by a governmental plan (if the employer is a tribal government), it did not give much guidance how the test would apply in other contexts.

In many cases, because of their lack of a tax base to fund government operations, tribal governments tend to have employees engaged in what might be considered to be commercial activities. For example, employees in a tribal forestry department are similar to state and federal employees, but their activities sometimes result in generation of revenue from timber sales. NCAI would also contend that if this test applied to contemporary state and local governmental workforces, they would also find it to be equally unworkable.

The Senate-passed version of the 2006 pension legislation (S. 1783, 109th Cong.), which had strong bipartisan support from members of this Committee, contained a much more administrable and equitable approach to the treatment of tribal governmental plans. Such language is reproduced below as follows.

**SEC. 1311. DEFINITION OF GOVERNMENTAL PLAN.**

> (a) Amendment to Internal Revenue Code of 1986- Section 414(d) of the Internal Revenue Code of 1986 (definition of governmental plan) is amended by adding at the end the following: `The term `governmental plan' includes a plan established or maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency instrumentality (or subdivision) of an Indian tribal

government, or an entity established under Federal, State, or tribal law which is wholly owned or controlled by any of the foregoing.'.
(b) Amendment to Employee Retirement Income Security Act of 1974- Section 3(32) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1002(32)) is amended by adding at the end the following: `The term `governmental plan' includes a plan established or maintained for its employees by an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency instrumentality (or subdivision) of an Indian tribal government, or an entity established under Federal, State, or tribal law that is wholly owned or controlled by any of the foregoing.'.

**Tribal Charities**

Under current federal tax law, the public charity status of section 501(c)(3) organizations funded by or formed to support Indian tribal governments is unclear. By contrast, the tax treatment of such charitable organizations funded by or formed to support federal, state and local governments is made clear by specific provisions of the Code (e.g., provisions treating such government funding as public support).

Consistent with the intent of the Tribal Government Tax Status Act to treat tribal government on par with other units of government, Congress should pass legislation to technically resolve this issue. The Senate has previously addressed it with a provision contained in Section 153 of the Senate-passed version of the Tax Administration Good Government Act (H.R. 1528, 108th Congress). That provision would have done the following: (1) treated tribal funding as public support for purposes of Section 170(b)(1)(A) (vi) (i.e., the public charity classification test that is satisfied on the basis of how much support a charity derives from "public" sources), and (2) treated charitable organizations formed to support Indian tribal governments the same as organizations formed to support state, local and federal government for purposes of Section 509(a)(3).

Unfortunately, the House and Senate did not go to Conference on that bill in 2006, although the provision was included in a bill passed by the House in 2007. This is a small technical fix that should be included in any comprehensive tax reform bill.

**Tribal Tax Parity in the Context of Streamlined Sales Tax Legislation**

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

At the same time, Indian tribal governments do have the authority to impose and collect sales taxes on any product sold within their territorial jurisdiction. Although not all tribes exercise this inherent authority, tribes are increasingly relying on the imposition of taxes on transactions within their territory as a stable and long-term revenue source for tribal government operations. For example, the Navajo Nation currently imposes a 4 percent general sales tax, which raises over $10 million dollars per year in revenue. In some situations, a tribal tax has to compete with applicable state taxes resulting in double taxation. However, in other cases, the state tax

may be preempted, particularly if the incidence of the tax would fall directly on the tribe or a tribal member for a transaction occurring in Indian Country.

Several bills are pending in the Senate that would clarify which state has the right to impose its tax on on-line or Internet sales transactions. However, neither S. 1452 (the Main Street Fairness Act) nor S. 1832 (the Marketplace Fairness Act) takes into account the taxing jurisdiction of Indian tribes with respect to sales that are sourced within Indian Country, particularly where the purchaser is the tribe or a tribal member.

NCAI would like to work with Senator Enzi and other interested members of the Finance Committee to craft appropriate amendments to the legislation in order to accomplish the following:

- Facilitate participation by federally recognized Indian tribal governments in the Streamlined Sale and Use Tax Agreement as "member states" if they meet certain conditions
- Make clear that the federal legislation is not intended to override longstanding principles of federal law governing the respective taxing jurisdictions of state and tribal governments, particularly with respect to purchases made by tribes and tribal members within Indian reservations and trust lands
- Protect existing bilateral agreements between states and tribes for the collection and allocation of sales tax revenues.

Statutory language contained in prior streamlined sales tax bills, such as S. 34 (introduced by Senator Enzi in the 110th Congress), could be used as a starting point to achieve these goals.

**Tribal Tax Parity and IRS Audits**

The Finance Committee has already heard testimony in previous committee hearings--in 2006 and 2008--regarding the disproportionate number of IRS audits focused on tribal bond offerings. The large number of tribal bond audits conducted by the IRS between 2002 and 2007, together with the restrictive approach taken by the IRS in these audits, had the effect of chilling the market for tribal bonds at a time when credit was otherwise available for government projects.

More recently, IRS audits have focused on the social welfare programs of tribal governments. Starting in approximately 2004, the IRS began a special audit focus on tribal government programs providing in-kind benefits to tribal members. As a result of that initiative, the IRS began focusing on tribal government programs, including the following:

- Health Care Programs
- Educational Programs
- Housing Programs (including preparation of reservation home sites for building, housing improvement, construction, down payment assistance, and maintenance/repairs)
- Loan Programs
- Emergency Assistance
- Cultural Events and Community Activities (e.g., powwows)

- Cultural Travel
- Elder Programs (including meals, social events and utility assistance)
- Legal Aid
- Recreation and sporting events
- Landscaping and grounds maintenance

The underlying premise of these IRS examinations appears to be that Indian tribal governments are paying out taxable income (whether in cash or in kind) to or on behalf of tribal members. The IRS is auditing the tribal governments based on the premise that they (as payors) have obligations to report such payments to the IRS (and the payees) by issuing 1099s, and, in certain cases, to also withhold tax on such payments.

In a June 28, 2007 to Senator Charles Grassley, Steven Miller, the then IRS Commissioner for Tax Exempt and Governmental Entities, made the following statements under the heading "Tribal Per Capita Payments":

> *Under the Indian Gaming Regulatory Act, revenues from tribal gaming can be used for several authorized purposes, including funding tribal government operations, providing for the general welfare of the tribe, and making per capita payments to tribal members. Per capita distributions are subject to Federal income tax, and the issuer must report the distribution on Form 1099.*
>
> *To reduce the tax consequences to tribal members,* ***some tribes have created mechanisms to classify what should be taxable per capita payments as general welfare program payments, excludible from income, often through liberal interpretations of what constitutes a "needs-based" program.*** *Others have created or invested in purported income deferral programs….*
>
> *To address this problem we have engaged in educational and enforcement activities. We also initiated* ***139 examinations during the past two years that focused specifically on the use of net gaming revenues.***

Further, the IRS Indian Tribal Governments (ITG) Work Plan for FY 2009 (posted on the IRS website at www.irs.gov/tribes) made the following statement about its Gaming Revenue enforcement initiative:

> *The Gaming Initiative commenced by the office of Indian Tribal Governments in FY2005 will continue into FY2009. Continuing discussions with the Chairman of the National Indian Gaming Commission indicate their extreme interest in ensuring that tribes appropriately use gaming revenues, and properly account for such use. Since they have limited oversight of that issue,* ***it falls upon the IRS to ensure that information reporting requirements are met with regard to the expenditure of such revenues****. With Indian gaming now surpassing $26 billion in gross revenue for 2007, and expected to grow by over $2 billion per year, our role and responsibilities will continue to expand. We plan to devote 6 FTEs to this initiative, and our examination goal includes 40 returns from this initiative."*

In testimony at a September 18, 2009 hearing before the Senate Committee on Indian Affairs on the IRS treatment of tribal government health programs, Sarah Hall Ingram, the current IRS Commissioner for Tax Exempt and Governmental Entities, denied that the agency was targeting

Indian tribal governments or that it had any special program to examine tribal health programs. Rather, Commissioner Ingram contended that "the issue of the taxability of medical benefits and health insurance coverage can arise from time to time in the normal course of an audit as we look at whether a tribe, or any other type of government or employer, is following appropriate information reporting and withholding practices as it administers its various programs."

More recently, on November 15, 2011, the IRS announced that it would be reexamining the applicability of the general welfare exclusion as applied to tribal government programs. Indian tribes have been asked to submit written comments to the IRS describing their programs, particularly the following.

- **Cultural** (for example, programs involving tours of sites that are historically significant to a tribe; language preservation programs; community recreational programs; cultural and social events);
- **Education** (for example, programs providing tutors or supplies to primary and secondary school students; job retraining programs for adults);
- **Elder programs** (for example, programs providing heating assistance or meals); and
- **Housing** (for example, programs providing housing on and off the reservation, with income limits different from those of the United States Department of Housing and Urban Development).

See IRS Notice 2011-94 at http://www.irs.gov/pub/irs-drop/n-11-94.pdf. As a result of this recent administrative focus, many tribal leader are concerned that IRS audits of tribal programs are likely to increase, along with potential tax withholding and reporting burdens imposed on tribal governments.

Notwithstanding IRS statements to the contrary, NCAI believes that the IRS actions in auditing tribal governments on their social welfare and other governmental programs are clearly not comparable to IRS treatment of state and local governments. There is no evidence that any similar audit initiative exists for state and local government programs. In addition to hearing testimony from the IRS at this hearing centered on broad concepts of tax reform, NCAI would like to invite the Finance Committee and its staff to conduct a full investigation of IRS examinations focused on tribal governmental programs. Such oversight lay the groundwork for a subsequent hearing focused exclusively on these audit activities, the legal authority for the audits and the financial impact of the IRS audits in Indian Country.

**Need to Evaluate the Effectiveness of Tax Incentives for Tribal Governments**

NCAI understand that the Committee is engaged in a review of numerous expired or expiring tax provisions and is in the process of reviewing their effectiveness. While a review of such incentives is beyond the scope of this statement, NCAI would like to offer its assistance in further evaluating the following incentives for Indian Country development.

- Accelerated Depreciation for Indian Reservation Property
- Indian Employment Tax Credit
- Indian Coal Credit
- Clean Renewable Energy Bonds (CREBs)
- New Markets Tax Credit

Based on initial feedback from NCAI members and supporters, we believe that providing Accelerated Depreciation for Indian Reservation Property has the potential to be a significant and meaningful incentive but only if it is enacted on a longer-term basis and appropriately targeted to encourage investment that would not otherwise occur. The Indian Employment Credit appears to be too complex and has not been widely utilized. We would also like to explore why the Clean Renewable Energy Bonds have not been allocated to any tribal government users. It is our understanding that the New Markets Tax Credit and Indian Coal Credits are considered to be effective incentives for economic and resource development.

**New Proposals**

NCAI would also like the Finance Committee to consider incentives that tribally-owned enterprises could actually use, including the following:

- Payroll Tax Credit for On-Reservation Employment
- Energy Tax Incentives that Tribes could Utilize More Effectively than CREBs.

NCAI looks forward to working with the Senate Finance Committee on these and other issues in the context of comprehensive tax reform.

NCAI is the oldest and largest Indian advocacy organization representing American Indian and Alaska Native governments and their members. For over sixty-years, tribal governments have come together as a representative congress through NCAI to deliberate issues of critical importance to tribal governments and to endorse consensus policy positions. NCAI has consistently worked with its member tribes and other Native American organizations on tax policy issues that our membership has deemed critical to growing tribal economies and providing governmental services.

**For further information regarding any of the topics discussed herein, please contact John Dossett, General Counsel or _____, _____ at (202) 466-7767.**

**Testimony of**
**John Yellow Bird Steele, President of the Oglala Sioux Tribe**
**Before the**
**United States Senate Committee on Finance**
**Tax Reform: What it Could Mean for Tribes and Territories**
**May 15, 2012**

Good Morning, Mr. Chairman and Members of the Committee. Thank you for holding this hearing. The question of IRS activities in Indian Country is an important one because the IRS has been burdening Indian tribes and tribal government efforts to foster a healthy community and a livable homeland on our reservations.

My name is John Yellow Bird Steele. I am the President of the Oglala Sioux Tribe, and I submit this testimony on behalf of my people. In our history, our people were a free and prosperous indigenous nation. We were self-governing, with a very democratic system of villages or tiyospayes, who chose our chiefs based upon merit and achievement. Our people are one of the Seven Council Fires, *Oceti Sakowin*, we held a vast territory from southeast Minnesota and Iowa through North and South Dakota, and Nebraska to Wyoming and Montana.

***Oglala Lakota History and Traditions***

Our Nation or Oyate always provided for all of our people through sharing and generosity. For example, if a man died and left his wife a widow with orphan children, his brother would take in the family and care for them. If he needed help, the whole community would help them. If elderly tribal members needed food or aid, the young people would help them. That is our tradition—we care for all of our people. As our great leader Crazy Horse said, "We preferred our own way of living, and we were no expense to the government." Our outlook is not so different from the rest of America, Congress says, "No child left behind." We say, "No one left behind."

The United States visited many injustices upon our people. In 1854, when a stray cow left behind by Mormon settlers on the road to Utah was found by a Lakota man travelling from the North, he brought it to his relatives for dinner. Then a U.S. Army platoon came out led by Lieutenant Grattan and confronted Chief Conquering Bear, demanding surrender of the man. The Chief explained that he had travelled on but offered three horses to replace the cow, while they were still talking Grattan and his men opened fire killing the Chief. His people defended themselves and killed Lt. Grattan and his command. The next year, President Pierce sent out General Harney on a punitive expedition to punish our people for defending ourselves, and at the Battle of Ash Hollow killed 86 men, women and children.

In 1866, the United States sent out a treaty delegation to Fort Laramie to negotiate a peace treaty, but the Army came with a column of men, horses and cannons to build forts in our Powder River Country. Chief Red Cloud said, "The Great Father sends us presents and wants us to sell him the road," Red Cloud said. "But the White Chief goes with soldiers to steal the road before the Indians say yes or no." That began Red Cloud's War to save the Powder River Country, and in the end, the United States abandoned its forts and sent out a treaty delegation. In our Sioux Nation Treaty of 1868, western South Dakota including the Black Hills was recognized as our permanent homeland, we reserved 44 million acres in Nebraska, Wyoming and Montana as "unceded Indian territory," and we reserved our original rights to self-government.

Yet, just a few years later, the United States sent out the Custer expedition to search for gold in the Black Hills and later ordered us to leave our lands, which were protected under the 1868 Treaty. When our people stood by our rights, President Grant sent out Custer, Crook and Terry with separate armed columns, leading to the Battle of the Rosebud and the Battle of the Little Big Horn. After we won the battles, the United States sent out more armies and our people were hunted in our own lands. We still have relatives who are war refugees in Canada.

We knew the value of the Black Hills, our sacred place and the Center of the Lakota Universe. The gold mine turned out to be the largest and most productive in the Western Hemisphere, with billions of dollars in gold mined. The theft of millions of acres of land left our people in poverty. As an elder, Chief Red Cloud reflected that the U.S. Government "made us many promises, but they only kept one. They promised to take our land and they took it."

Today, Shannon County, South Dakota, on the Oglala's Pine Ridge Reservation is the third poorest county in the Nation, as measured by per capita income by the U.S. Census Bureau in 2010. Our relatives on the Cheyenne River Sioux Reservation live in the poorest county in the Nation, Ziebach County, South Dakota and our relatives at the Rosebud Sioux live in the second poorest county in the Nation. The Standing Rock Sioux have the 7th and 9th poorest counties in the Nation on their reservation, Corson County, South Dakota and Sioux County, North Dakota. So, together on the original lands of our Great Sioux Reservation, we have 5 of the 10 poorest counties in the United States.

Chief Red Cloud said, "I am poor ... but I am the Chief of a Nation. We do not want riches but we do want to train our children right. Riches would do us no good. We could not take them with us to the other world." Today, although our people are poor, we are proud and we stand on our Treaties. We call upon the United States to respect our Treaties, as part of the Supreme Law of the Land.

The 1868 Treaty sets apart our land for our "absolute and undisturbed use" as a permanent home and recognizes our right to self-government. In *Ex Parte Crow Dog* (1883), the Supreme Court said that our Treaties reserve "the highest and best

form of government" to our people, *self-government.* Today, we rely on our original sovereign authority to provide for our people as a Native Nation.

***IRS Interference with Tribal Self-Government***

Indian tribes are sovereign governments that pre-date the formation of the United States. Indian tribes are the original American democracies. Our right to self-determination as indigenous peoples must be protected under international human rights laws, and indeed, the Constitution of the United States recognizes the original and continuing status of Indian tribes as indigenous sovereigns, implicitly and explicitly, in the Constitution.[1]

As a result, Indian tribes are recognized as governments and not taxable entities under the Internal Revenue Code. The Tribal Government Tax Status Act, 26 U.S.C. sec. 7871, is a reflection of our government status. In 1924, under the Indian Citizenship Act, non-citizen Indians were made U.S. citizens:

> *Provided That all non citizen Indians born within the territorial limits of the United States be, and they are hereby, declared to be citizens of the United States: Provided That the granting of such citizenship shall not in any manner impair or otherwise affect the right of any Indian to tribal or other property."*

Act of June 2, 1924. June 2, 1924. [H. R. 6355.] [Public, No. 175.] SIXTY-EIGHTH CONGRESS. Sess. I. CHS. 233. 1924. The Indian Citizenship Act was not intended to disturb tribal citizenship or the rights of individual Indians to tribal property or lands. Accordingly, the Supreme Court has held that individual Indian income that is derived from trust lands is not subject to income taxation. *Squire v. Capoeman,* 351 U.S. 1, 76 S.Ct. 611, 100 L.Ed. 883, (1956). Taken together, the Constitution, treaties, and statutes of the United States make clear that our tribal citizens should not be taxed by the Federal Government, our Trustee, based upon tribal government programs or services derived from tribal trust property or designed to make our reservations livable homes.

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[1] The Constitution of the United States recognizes Indian tribes as sovereigns, with authority to enter into Treaties and conduct international relations in the Treaty Clause. By the authority of the Supremacy Clause, our Sioux Nation Treaties are part of "the Supreme Law of the Land." The Apportionment Clause excludes "Indians not taxed," from taxation and apportionment of Congress. After almost a century of treaty-making and more than 370 treaties, the 14th Amendment affirmed the original provisions by treating tribal members as citizens of Indian nations, not the United States, in the Citizenship Clause and by reaffirming the status of "Indians not taxed" in the Apportionment Clause as amended to do away with the original references to slavery.

Nevertheless, the IRS has become a menacing, interfering and overwhelming bureaucracy in Indian Country. The IRS apparently has an unspoken plan to audit each and every Indian tribe in the country, in a harassing manner that negates Indian sovereignty and interferes with our relationship with our tribal members.

The IRS has sent an audit form to our Oglala Sioux tribal government, which seeks records of:

- Payments to employees, Council Members, tribal members, including expense reimbursement, distributions from gaming revenue, fringe benefits, bonuses, and accountable plans.
- Petty Cash records.
- Gifts and loans to tribal members and/or employees with related documents.
- Health care, educational benefits, legal advice/representation, utility assistance, housing assistance, recreational activities provided on behalf of tribal members and employees.
- Pow-wow prizes and related tribal contest prizes.
- All bank records, credit card statements, expense receipts, and tribal government program plans.

This is what we would call a fishing expedition. There is nothing that says that the Oglala Sioux Tribe has not complied with the IRS, but the IRS is imposing a burden—a tremendous burden—on us and that interferes with our self-governance.

In 2009, just as Congress was preparing to pass the Obama Health Care Plan, the IRS was seeking to tax health care benefits provided by Indian tribes to our tribal members. Federal employee benefits were not taxed. Veteran's benefits were not taxed. The Indian Health Service benefits were not taxed. Prisoner's health care benefits were not taxed. State employee health care benefits were not taxed. Medicare, Medicaid, and children's health care benefits were not taxed. Yet, the IRS wanted to tax tribal government health care. Congress rejected that, enacting a law that says the IRS may not tax health care benefits, insurance, or care provided by tribal governments to our tribal members.

The IRS explains the meaning of Section 139(d) of the Patient Protection and Affordable Health Care Act:

> Section 139D provides, in general, that gross income does not include the value of any qualified Indian health care benefit. Section 139D defines the term "qualified Indian health care benefit" to mean:

- any health service or benefit provided or purchased, directly or indirectly, by the Indian Health Service (IHS) through a grant to, or contract or compact with, an Indian tribe or tribal organization, or through a third-party program funded by the IHS;

- medical care provided or purchased by, or amounts to reimburse for medical care provided by, an Indian tribe or tribal organization for, or to, a member of an Indian tribe, including a spouse or dependent of the member;

- coverage under accident or health insurance (or an arrangement having the effect of accident or health insurance), or an accident or health plan, provided by an Indian tribe or tribal organization for medical care to a member of an Indian tribe, including a spouse or dependent of the member; and

- any other medical care provided by an Indian tribe or tribal organization that supplements, replaces, or substitutes for a program or service relating to medical care provided by the Federal government to Indian tribes or their members.

IRS Website.

I mention this to show that the IRS does not even follow Congress's guidance when there is a clear mandate to stop taxing tribal government health care, health insurance and medical assistance programs—the IRS included an audit of tribal health programs in its notice which we were asked to comply with this year!

The IRS is now asking Indian tribes throughout the country to submit justifications for not taxing tribal government programs for child care, elder care, education, housing, heating assistance, burial assistance, and cultural activities, such as pow-wows and tribal celebrations.

We believe that the IRS is employing a discriminatory double standard. For example, the United States provides housing to the President, the White House and Camp David, etc. Is the President taxed for his housing benefits? No.

Yet, the IRS wants to audit housing benefits, such as surplus FEMA trailers provided to tribal members, who have no access to a real house. My daughter's family lives in a house with no running water—they have to use an outhouse for sanitation. Our people are found by the Census Bureau to be the poorest people in the country, with 47.3% of our people living below the poverty line.

We do not mean to suggest that the President should be taxed for living in the White House. We support the President and the Congress, and the United States

has good reason for not taxing the President's housing benefits. Naturally, we have good reasons for seeking FEMA trailers for our people who otherwise would not have a home. Similarly, the United States has good reasons for providing for the President's travel expenses aboard Air Force One, Marine One, in limousines, etc. Those are not taxed. We have good reasons for providing per diem payments to our Tribal Council Representatives. We should not be harassed about providing for our Tribal Council because it is our governing body, central to our treaty-protected original, inherent rights to self-government.

For another example, Indian tribes often have burial programs to assist our tribal citizens. In the past, Native Nations gathered to help our communities and families send their loved ones on the journey to the spirit world. Today, Indian tribes honor that tradition by assisting with burials and, typically, Tribal Leaders will make strong efforts to attend funerals of tribal citizens. Also, it is important for tribal elders and ceremonial leaders to attend and participate in the funeral events. The United States should not interfere with our cultural and community traditions, whether it acts through the IRS or any other agency. Yet, the IRS wants to review tribal government burial assistance programs. Who would the IRS tax? The deceased husband and father? Or the grieving widow and children?

The United States pays for Veteran funerals with military salutes and fanfare at a price that may exceed $15,000. Yet, the IRS does not seek to tax the Veterans or their families because the United States has a very good reason for providing the funeral assistance. We do not question that, and, in fact, we agree support it. All we ask is that the IRS provide us with the same courtesy when we provide burial assistance.

Churches provide funeral assistance to parishoners. Is the IRS seeking to tax the church or its members for the food service that they provide to support families burying their relatives? Is the IRS seeking to tax church members for the church plots that may be provided in the church yard? No.

Indian tribes are singled out for discriminatory tax treatment.

***The Indian Self-Determination Policy Mandates Respect for Indian Sovereignty***

President Franklin D. Roosevelt initiated a policy of respect for tribal self-government in the Indian Reorganization Act. Although we went through a terrible period under the so-called Termination Policy in the 1950s, led by Senator Arthur Watkins from Utah, President Eisenhower called for Public Law 280 to be amended to require tribal consent to state assumptions of jurisdiction in Indian Country.

Presidents Kennedy and Johnson turned away from the Termination Policy and began the Indian Self-Determination Policy. President Johnson included Indian tribes in the War on Poverty, establishing a Cabinet level working group on Indian self-determination and economic assistance. President Johnson signed the Indian

Civil Rights Act into law, securing basic civil rights for tribal citizens and requiring tribal consent to any further assumption of jurisdiction under Public Law 280.

President Nixon brought forth the Indian Self-Determination and Education Assistance Act and officially repudiated the Termination Policy, in a Special Message to Congress supporting Indian Self-Determination. President Reagan supported tribal economic development, self-determination and self-sufficiency and sought to cut the bureaucratic red-tape that has historically been imposed on Indian tribes. He initiated the Federal tribal government-to-government relations policy. President Reagan also signed the Indian Gaming Regulatory Act into law. President George H.W. Bush continued President Reagan's policies.

President Clinton issued Executive Order 13175 (2000), Consultation and Collaboration with Indian Tribal Governments, to respect Indian sovereignty, self-government and self-determination. Accordingly, the Executive Order explains: "The United States recognizes the right of Indian tribes to self-government and supports tribal sovereignty and self-determination." The Executive Order states further that:

> Our Nation, under the law of the United States, in accordance with treaties, statutes, Executive Orders, and judicial decisions, has recognized the right of Indian tribes to self-government. As domestic dependent nations, Indian tribes exercise inherent sovereign powers over their members and territory. The United States continues to work with Indian tribes on a government-to-government basis to address issues concerning Indian tribal self-government, tribal trust resources, and Indian tribal treaty and other rights.

Both President George W. Bush and President Obama have reaffirmed Executive Order 13175. The Executive Order provides direction to Federal agencies on agency rulemaking:

> (a) Agencies shall respect Indian tribal self-government and sovereignty, honor tribal treaty and other rights, and strive to meet the responsibilities that arise from the unique legal relationship between the Federal Government and Indian tribal governments....
>
> (c) When undertaking to formulate and implement policies that have tribal implications, agencies shall:
>
> (1) encourage Indian tribes to develop their own policies to achieve program objectives;
>
> (2) where possible, defer to Indian tribes to establish standards; and
>
> (3) in determining whether to establish Federal standards, consult with tribal officials as to the need for Federal standards and any alternatives that

> would limit the scope of Federal standards or otherwise preserve the prerogatives and authority of Indian tribes.

In sum, the Department of the Treasury and the IRS are directed by the President to "preserve the prerogatives and authority of Indian tribes."

Instead, the IRS has been acting under a negative cultural bias and interfering with tribal self-government. For example, in recent years, the IRS has sought to tax tribal government health care and health insurance. Federal health care was not taxed, state health care was not taxed, local government health care was not taxed, and employer provided health care was not taxed. Congress ended this discrimination in the Obama Health Care Law. Yet, Indian tribes should not have to seek a change to every law.

In general, treaties protect tribal self-government and the courts construe subsequent statutes as not impacting tribal self-government unless Congress has evinced an express intention to do so. Tribal government provision of programs and services is protected as an aspect of self-government by the Indian Gaming Regulatory Act, which mandates the provision of such services prior to payment of any per capita payments to individual members. IGRA makes the per capita payments taxable, drawing a clear distinction from tribal government programs and services, which are not taxable. 25 U.S.C. sec. 2710.

The IRS should respect the traditional areas of tribal self-government, including:

- **Housing**. Wars, non-Indian encroachment and Indian treaties limited aboriginal tribal homelands, typically making it necessary for native peoples to abandon traditional housing and adopt American-style housing to deal with different climate conditions. Recognizing that Indian tribes have typically been relegated to remote and often uneconomic reservations, the IRS should acknowledge that Indian tribes as governments must provide assistance to tribal citizens in the area of housing in accordance with reasonable standards of American housing to make our reservations livable homelands. This is vitally important to the general welfare of Native Nations and tribal communities.[2]

- **Education**. The United States destroyed traditional Native American lifeways by limiting our territory, killing the buffalo, taking our hunting, fishing and farming areas, taking our natural resources and taking our lands

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[2] Typically, Indian tribes provide adjunct services to make reservations liveable homes for tribal citizens, as envisioned in treaties, statutes, and executive orders. For example, many tribes provide adjunct heating assistance to deal with freezing cold climates, water to assist in making homes liveable, or sewer and sanitation services to make reservation lands habitable. These programs should not be interfered with by the Federal Government.

for numerous Federal purposes—including non-Indian homesteading, park lands, forest lands, national grass lands, wilderness preserves and military bases, among other things. The treaties promised education in return for huge takings of lands and the United States has not fulfilled those promises. More recent statutes establish new pledges to promote the education of tribal children, youth and adults. Accordingly, it is the policy of the United States to promote education. When tribal governments provide education services through tribal colleges and universities or grants and scholarships to attend state or local colleges and universities, the United States should recognize that tribal governments are providing for the general welfare of tribal citizens. Our tribal educational services should not be subject to taxation by the United States.

- **Child Care and Elder Care.** The United States provides child care through programs such as Headstart and those are not taxable. The IRS should recognize that Indian tribes have unique traditions of child care, where the community was typically involved in providing assistance to raise Indian children in accordance with Indian culture. As the Indian Child Welfare Act acknowledges, Indian children are the most precious resource of Indian tribes and due to a history of taking Indian children away from family homes through boarding schools and forced adoption, Indian tribes need to assist Indian children in growing up in a nurturing environment. Elders are venerated in Indian tradition and provide the critical repository of culture, language and religion for Indian societies, who rely on our oral traditions. Accordingly, tribal governments traditionally provide care for elders, such as hot meals, access to education programs, heating assistance and small subsistence payments. Tribal government program choices should be respected, even though they may not precisely mirror Federal programs.

- **Cultural Programs.** Tribal governments must foster tribal cultures because our native cultures are unique and have a great value to Native Nations and tribal communities. The United States over a period of generations has spent billions of dollars to strip us of our cultures through unconstitutional religious proselytizing, outlawing our religions, forbidding our children to speak our languages, forcible separation of our children from our families, and programs to replace native cultures with "American" culture. None of these efforts were taxed by the IRS. Nor should the IRS tax tribal cultural programs. Congress has evinced a policy to the promote native cultures and languages through the American Indian Religious Freedom Act, the Native American Graves Repatriation Act, native language acts, and the establishment of the National Museum of the American Indian. The IRS would not tax a field trip to Washington, D.C. to go to NMAI. It must not tax trips to pow-wows, tribal gatherings and celebrations, trips to historic sites, or trips to neighboring Indian tribes.

There are many other programs that Indian tribes provide to tribal members that are traditional and cultural in nature.

***The IRS General Welfare Doctrine Review***

Due to numerous complaints from Indian tribes around the country, the IRS has requested comments on its General Welfare Doctrine and the tribal government programs that may qualify for exclusion from income under its provisions. Yet, we do not trust the IRS to recognize tribal rights because, historically, the IRS has done everything it can to minimize tribal government rights. When one Tribal Leader raised objections to IRS intrusion based upon tribal treaty rights, he was told, "You can read your treaties in prison, if you like."

Tribal governments need legislation to protect treaty rights, the undisturbed use and occupancy of our reservations as "permanent homes," and self-government. Legislation should include the following elements:

> **Findings.** The United States has entered into hundreds of treaties with Indian tribes, which guarantee tribal self-government, tribal lands as permanent homelands, and establish a Federal trust to protect tribal property.
>
> The United States must not tax income derived from tribal or individual Indian trust property or trust land.
>
> The United States encourages tribal self-government and tribal self-sufficiency, so the United States should not interfere with tribal government efforts to provide tribal government programs and services to tribal members.
>
> The United States should not burden Tribal Councils with taxation for tribal per diem, expenses and stipends because that burdens tribal self-government.
>
> Specifically, the following tribal government programs should not be burdened or taxed by the IRS:
>
> - **Child Care.** The United States recognizes that our children are our most precious resource and there are many Federal programs, so tribal government child care programs should be excluded from taxation.
>
> - **Elder Care.** Our elders hold the cultural knowledge and history of our people. We must support them in their later years because they are our past, present and provide the traditional based for our future.

- **Education.** The United States promised in our treaties to provide education, instead our children were ripped away from parents and family support to go to government boarding schools far from home. They were stripped of language and culture and returned home as strangers. As we seek to educate our children and redress these historical wrongs, the IRS should not be burdening us with taxes for services that the Federal Government pledged to provide.

- **Housing.** Our people have suffered substandard housing for many generations in our alternating freezing winter cold and high summer heat. Tribal governments must be able to provide decent housing for our people without Federal Government interference, that includes utility assistance and home repairs.

- **Police, Fire Protection, and Transportation.** Clearly, public safety is a public good, including police and fire protection, and transportation. Because we have inadequate medical facilities on our reservation, we often have to medevac patients out to Rapid City or other regional centers. We need to support their families to travel with them to help in these crises. The IRS should not burden these programs.

The Great Plains Tribal Chairmen's Association has passed a resolution calling for such legislation, and we request your support to enact the legislation. Stop the IRS from wrongfully interfering with tribal self-government, treaty rights, trust lands and resources, and Indian homelands. The Great Plains Tribal Chairmen's Association Resolution provides:

> **WHEREAS,** After many years Tribes in Indian Country have instituted programs to provide governmental benefits to their Tribal citizens; and
>
> **WHEREAS,** Internal Revenue Service is auditing the benefits provided to individual Tribal citizens by their Tribal Government; and
>
> **WHEREAS,** the Internal Revenue Service is violating our treaty rights to the absolute and undisturbed use and occupancy of our reservations as permanent homelands and is interfering with the governmental relationship between our Tribal Governments and tribal citizens; and
>
> **WHEREAS,** The IRS discriminatory approach to the auditing of Indian tribes is a severe problem, given the fact that the 5 of the 10 poorest counties in the country are within our Indian reservations in South and North Dakota; and
>
> **WHEREAS,** The Internal Revenue Code Section 61 states that, except as otherwise provided, gross income includes all income from whatever source

derived, and the Internal Revenue Service and federal courts have consistently held that payments made under similar social benefit programs for the promotion of general welfare are not includable in gross income; and

**WHEREAS,** the general welfare doctrine provides a common law (or statutory interpretation by implication) exclusion for government social welfare programs, the test is based on facts and circumstances (or an IRS agent's personal value judgment) and is difficult to apply.

**WHEREAS,** The General Welfare Doctrine as applied by the IRS interferes with treaty rights, self-government, and the absolute and undisturbed use and occupancy of our homelands and discriminates in favor of Federal and state programs and against tribal government programs based upon the non-Indian value judgments of IRS agents;

**WHEREAS,** Statutory language is needed to clarify that governmental benefits provided by Indian tribal governments for their members is not subject to income taxation; and

**WHEREAS,** Federal legislation to amend the Internal Revenue Code is needed that would clarify that governmental benefits provided by an Indian tribe to its members is not subject to income taxation; and

**WHEREAS,** This legislation would apply to governmental benefits provided after the date of enactment. It also includes language to prohibit the IRS or the courts from assuming or inferring that benefits provided by Indian tribes that are not within the scope of the bill were taxable prior to the legislation's effective date.

**NOW THEREFORE BE IT RESOLVED,** The Great Plains Tribal Chairman's Association calls upon the United States to honor our treaties, agreements, and the executive orders issued in order to honor our treaties and agreements by ceasing and desisting the IRS' efforts to tax our tribal government programs and services to tribal citizens which interferes with our Tribal Government relationship with our tribal citizens, violates our homelands, and violates our right to tribal self-government;

**BE IT FURTHER RESOLVED,** The Great Plains Tribal Chairman's Association supports legislation to treat tribal government educational and other benefits as an aspect of tribal self-government and tribal civic life, not personal income to individual tribal members.

***Conclusion***

The IRS has embarked on audits of Indian tribes that we believe are very discriminatory. These audits seek to identify tribal government programs that are

providing government services to tribal members and to assess them as income to be subject to Federal taxation. We do not believe that the same audits are being conducted on Federal, State and local governments or foreign nations.

The IRS should halt this discriminatory auditing of Indian Country. Instead, consistent with the Constitution, treaties, statutes, and executive orders of the United States, the IRS should defer to Indian tribal governments providing tribal government services to tribal citizens. The IRS should recognize that Indian tribes as governments have long sought to promote the health and vitality of Native Nations and tribal communities, including tribal languages, cultures and religions. Treaties, statutes, and executive orders establish indigenous homelands, where tribal self-government is protected. The IRS should not interfere with Indian tribes' governmental programs and services designed to provide a decent way of life for tribal citizens.

We need legislation to put the IRS back on track. We respectfully request that you include legislation to direct the IRS not to interfere with tribal self-government, treaty rights, trust lands and resources, and the absolute and undisturbed use of our Indian reservations as permanent homelands. Federal law requires as much, but the IRS refuses to listen. Please act now.

Thank you for your thoughtful consideration of this important government-to-government request for assistance.

"They made us many promises, more than I can remember, but they kept only one; they promised to take our land, and they did."

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