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Re: Non-Gaming Economic Development

This memorandum is provided to discuss the avenues in which a Tribe may organize business entities that is provided in response to several of the discussions over the last several days. As you may know, the choice of business structure will have long-term and far-reaching consequences for a tribal government and tribal business. The business structure the Tribe chooses will have a major impact on how tribal assets are protected, how tribal sovereignty is preserved, and how potential liability is minimized. Critical decisions regarding the tax status of the business entity and whether or how sovereign immunity is waived must be made early in the decision making process. Key factors to consider when trying determining the best structure for a particular activity are:

- **Segregate politics from business.** Free the tribal council from micro-managing tribal businesses while allowing the council to focus on long-term development strategies and goals. Assign responsibility to operate and manage tribal businesses to those who have business skill and knowledge.
- **Organizational considerations.** How the entity is formed, under what law is the entity formed, and who manages the entity.
- **Sovereign Immunity.** Tribes as governmental entities are not subject to suit unless they clearly waive immunity or Congress has waived their immunity. This raises questions regarding the ability of lenders, investors, and business partners to enforce agreements and to protect their investment. Each entity has different sovereign immunity implications that must be considered.
- **Liability.** Some business structures effectively shield business owners from liability for the financial obligations and debts of the business. Others do not effectively separate owner obligations from business entity obligations.
- **Tax considerations.** Different federal income tax rules apply to different business types. State tax liability frequently depends on whether the business activity is conducted on or off an Indian reservation.
- **Financing.** Money for a business comes in two forms: (1) debt--whereby the business borrows and then owes money to others; and (2) equity--where investors provide funding

and then own part of the business. Lenders generally do not dictate choice of business entity, but equity investors may specify what business structure you can choose.

Section 16 Organizations

In 1934, Congress enacted the Indian Reorganization Act (IRA) to encourage economic and political self-determination by permitting tribes to organize their tribal governments under constitutions adopted pursuant to Section 16 of the IRA. Tribes had the option to accept or reject the IRA. Tribes that chose to organize their government under Section 16 of the IRA adopted a Tribal Constitution that was reviewed and approved by the Secretary of the Interior. Tribal constitutions adopted under Section 16 of the IRA typically established a system of centralized government with a chief executive, usually a Tribal Chairman or President, a legislature, usually a Tribal Council, a Tribal Business Committee, or Board of Directors that was vested with legislative and executive powers, and a weak judiciary. Tribal governments often directly control or participate in business activities through unincorporated instrumentalities of the tribe. These are often referred to as an economic arm of the tribe. These instrumentalities or arms of tribal government are not considered to be distinct legal entities.

Unincorporated Instrumentalities

Unincorporated instrumentalities of a tribal government are formed under tribal law for commercial purposes and share the same legal characteristics of the tribal government because they are not separate legal entities. A tribe's constitution and by-laws or codes may provide tribal governments with the power to create and operate subordinate economic entities. These entities are generally established by tribal resolution or by tribal ordinance and are usually directly controlled by the tribal government and its tribal council to serve as the development arm of the tribe. Sometimes a tribal enterprise may have a board of directors, but it is usually comprised of tribal council members. An unincorporated instrumentality often has a manager in charge of its day-to-day operations.

A. Sovereign Immunity

When a tribe establishes an entity to conduct certain activities in this manner, the entity is immune from suit if it is functioning as an arm of the tribe such that its activities are appropriately deemed to be those of the tribe. Courts have rejected attempts to limit sovereign immunity to the governmental activities of a tribe and have found tribes to be immune from suit for business activities if operating as an arm of the tribe. A tribal instrumentality or unincorporated enterprise of a tribal government, however, cannot unilaterally act to waive tribal sovereign immunity except in accordance with tribal law.

Many courts have found that subordinate economic entities of the tribe created for commercial purposes share the same immunity as the tribe itself. Tribal sovereign immunity can create uncertainty and risks for would-be investors or business partners. For instance, agreements may not be enforceable where one party (e.g., a tribe or tribal entity) is immune from suit. In many disputes regarding tribal commercial activities, an issue is raised regarding whether a tribe has waived sovereign immunity. An Indian tribe cannot be sued unless there is a clear waiver of sovereign immunity by the tribe itself or a clear abrogation of immunity by an Act of Congress. However, a tribe may waive immunity by contract or agreement, by tribal ordinance, by resolution, or by its corporate charter. Such waiver must be in accordance with valid tribal law,

such as a constitution and by-laws, by tribal code, or other provision which authorizes the waiver and permits tribal officials to execute contracts.¹

One of the disadvantages of forming a tribal business entity as an unincorporated instrumentality of a tribal government is that the sovereign status of the tribe may impede a tribe's ability to obtain credit and financing for its business transactions if agreements are not enforceable through judicial action. Also, if a tribe does waive its immunity from suit through a tribal instrumentality, it may subject the assets of the tribe to potential liability for the obligations of the tribal instrumentality. Since there is no separate legal entity conducting business, the assets and obligations of the tribe are intermingled with the business.

B. Tax Treatment

The IRS has generally treated an unincorporated instrumentality or business operated directly by a federally recognized tribe as not subject to federal income tax, again because it is not considered to be an entity separate from the tribe itself.²

C. Financing Considerations

A tribe operating an enterprise as an arm of the tribal government may have difficulty with the following issues:

- Ability to enforce agreements--Lenders will be reluctant to provide credit if they are not certain that they can enforce their contract against a tribal enterprise that is an arm of the tribe because, like the tribe, it will be immune from suit.
- Collateral and Security Interest--A conventional lender will also want collateral or a security interest so that its investment is protected if there is a default or the enterprise is not successful. An enterprise operating as an unincorporated instrumentality of the tribe and its governing body will not have separate assets or property to pledge as collateral. Rather, tribal assets would have to be pledged and there will be no limitation of liability.

D. Tax-Exempt Bonding

¹Tribes have granted limited waivers of sovereign immunity. Waivers can be limited in a number of ways. A waiver can be limited to (1) a specific tribal asset or enterprise revenue stream, (2) a specific type of legal relief sought by performance of the contract and not money damages, (3) a claim limited to the amount borrowed, or (4) a specific enforcement mechanism, such as court or arbitration.

² There is no per se exemption from federal income taxation when a tribe organizes as an "instrumentality." To be considered a nontaxable entity, the instrumentality must be operating as an arm of the tribe, and not organized as a separate legal entity. In determining whether an entity qualifies as a government instrumentality, the IRS generally looks at the following six factors: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more governmental units (e.g., a state, a tribe or political subdivision); (3) whether there are any private interests involved, or whether the governmental unit has the power and interest of an owner; (4) whether control and supervision of the organization is vested in a public authority or authorities; (5) whether express or implied statutory or other authority is necessary for the creation and/or use of the organization, and whether this authority exists; and (6) the degree of financial autonomy of the entity and the source of its operating expenses. If it meets this multi-factor test, an instrumentality will qualify for tax benefits reserved to governmental entities--such as the ability to receive charitable contributions or to issue tax exempt bonds.

Section 103 of the Tribal Governmental Tax Status Act permits tribal governments to issue tax exempt bonds. When a tribe issues tax exempt bonds, the investors in such bonds are able to earn interest free of tax. Thus, all other factors being equal, such bonds should yield lower interest rates than taxable debt. Bond financing (whether taxable or tax-exempt) also has the advantage of allowing the borrower to spread repayment of principal and interest over a longer period. Only Indian tribal governments and their political subdivisions are qualified issuers of tax exempt debt. Furthermore, the IRS has ruled that Indian entities qualifying as an "instrumentality" of one or more government units may use tax exempt financing, and such use will not constitute a "private business" use. In addition to meeting these tests, which focus on the identity of the person issuing the bonds (or on whose behalf the bonds are issued), all tribal tax-exempt debt must finance facilities that serve an "essential governmental function." Section 7871 does not define an essential government function, but Section 7871 states that it does not include functions not customarily performed by state or local governments. The interpretation of the "essential governmental function" test has spawned a number of controversies between the IRS and tribes.

E. Advantages and Disadvantages

The advantages of operating a business as an unincorporated instrumentality of the tribe include:

- Easy to form since it is formed as an arm of the tribal government--no need to set up a separate legal entity
- Management is centralized through tribal governmental officials
- Entity will have the same privileges and immunities as the tribal government including tribal sovereign immunity
- Not subject to federal income tax
- Section 81 approval by the Secretary of the Interior required if contracts or agreements encumber Indian land for a term of 7 years or more.

Disadvantages include:

- Politics and business not separated
- Assets and liabilities of the enterprise are not segregated from governmental assets
- Wholly-owned tribal entity--would preclude equity ownership in enterprise by outside investors. A major disadvantage of an unincorporated instrumentality of the tribe is that it does not separate politics from the day-to-day business operation of the tribe and the tribe assumes liability for all of the obligations and liabilities of the enterprise. This can result in micro-managing of a business enterprise which may hinder the tribal council's ability to set overall strategic economic development objectives.

Political Subdivision of Tribal Government

Political subdivisions are increasingly utilized by Indian tribal governments as quasi-business entities because of the close link between economic development (a governmental function) and tribal ownership and conduct of businesses. In some cases, such subdivisions are being formed as Economic Development Authorities that serve as holding companies for business entities owned by the tribe and as regulatory bodies for business operations within the tribe's jurisdictional area.

A political subdivision of an Indian tribal government is a unit of the government that has the following characteristics:

- Is, to some degree, separate from the government itself
- Is created under tribal law to fulfill a substantial governmental function of the government
- Has been delegated a sufficient amount of one or more recognized sovereign powers of the tribe. Recognized sovereign powers include, for the purpose: (1) the power to tax; (2) the power of eminent domain; and (3) a police or regulatory power.

A. Sovereign Immunity and Liability.

Sovereign immunity generally extends to political subdivisions of Indian tribal governments. Like an instrumentality, a tribal political subdivision shares the same attributes of tribal sovereignty as the tribe.

B. Tax Treatment

The IRS has ruled that the income earned by a state, a political subdivision of a state, or an integral part of a state or political subdivision "is generally not taxable in the absence of specific statutory authorization for taxing such income." As noted above, the IRS has taken this same approach to the taxation of income earned by Indian tribes, their unincorporated businesses, and their section 17 corporations. The IRS has also ruled privately that a political subdivision of an Indian tribe was not required to file income tax returns.

Section 7871 treats Indian tribal governments and their political subdivisions like state governments for specific tax purposes. The Internal Revenue Code provides a relatively large number of tax benefits for state and local governments. Not all of these benefits are extended to tribal governments. Under Section 7871, the following benefits are available to tribal governments and their political subdivisions:

- Tax deductibility of charitable contributions for income, estate and gift tax purposes
- Certain governmental exemptions from specific excise taxes levied on fuels, manufactured goods, communications, and certain highway vehicles (all contingent on the purchase or sales transaction involving the exercise of an "essential governmental function")
- Tax deductibility of tribal taxes

- Authority to issue tax-exempt bonds for facilities that serve an "essential governmental function"
- Certain health and retirement annuity plan purposes (but not the treatment of tribal pension or retirement plans generally as "governmental" plans)
- Excise taxes rules related to excess lobbying expenditures and private foundations.

C. Financing Considerations

One of the major advantages of establishing a political subdivision for economic development or business activities is that such an entity can be both the borrower and the issuer in a tax-exempt financing. When the subdivision, and not the tribal government itself, is the issuer/borrower, overly invasive disclosure of tribal financial records may be avoided. Where the facilities or operations to be financed do not meet the essential governmental function test under section 7871 for tax-exempt bond financing, the political subdivision may seek or arrange other types of financing.

D. Advantages and Disadvantages

Advantages of conducting economic development and business activities through a political subdivision include the following:

- Relative certainty of federal tax treatment
- Likely retention of state tax immunity
- Retention of sovereign immunity (except where waived or limited for specific purposes)
- Ability to form the equivalent of a corporate board with a governmental focus
- Use of the subdivision as both a regulatory body and as a holding company for subordinate and separately organized business entities.

Disadvantages of conducting economic and business activities through a political subdivision include the following:

- Time and expense associated with the formation of the entity, including the requisite federal agency approvals that must be obtained (first by BIA, and then IRS)
- Political subdivisions do not have all of the flexibility associated with ordinary business entities, such as corporations and LLCs
- Certain business partners may not be comfortable dealing with any type of governmental entity.

Tribally-Chartered Corporations

A tribally chartered corporation is a corporation that is organized under a tribal statute or code or pursuant to a resolution of an authorized tribal legislative body. A corporation is a business entity that has the following characteristics: (1) limited liability (i.e., the liabilities of the corporation do not automatically become liabilities of the corporation's owners); (2) transferability of ownership interests; (3) centralized management, generally in the form of a board of directors; and (4) continuity of life (i.e., it exists until formally dissolved). The legal characteristics, capabilities and limitations of tribally-chartered corporations are all determined under the law of the chartering tribe.

A. Relationship to Tribal Government

When a tribe forms a wholly-owned corporation, it generally expects to retain overall control of the corporation while, at the same time, segregate the corporation's business affairs and assets from the operations of its government. Thus, while the tribe may be the sole shareholder of the corporation, the corporation will likely be managed by its own board of directors. The board of a tribal corporation will generally have some degree of autonomy from the tribe's elected leadership. The extent to which a tribal law corporation has autonomy from the tribal government may determine in large measure whether it can claim to share the same immunity from suit as the government itself.

B. Sovereign Immunity and Liability

One of the key characteristics of any corporation is limited liability. In the corporate context, limited liability means that the shareholders of a corporation are generally not personally liable for the debts of the corporation in which they own stock. When a corporation is wholly owned by a tribe, the tribal corporation's organizing documents or other law should make clear that the tribe is under no obligation to the corporation or its creditors--other than to the extent of its contributed capital or other consideration for the shares that it owns. However, if a corporation that is wholly owned is not treated as a separate legal entity by its owner or if corporate formalities are ignored, the creditors of the corporation could seek to "pierce the corporate veil" in order to access tribal assets. Anticipating the possibility of corporate veil piercing, many tribal corporation statutes, ordinances or organizing documents also make clear that by incorporating or operating a corporation, the tribe should not be deemed to have waived its sovereign immunity from suit or any other privileges of sovereignty. In certain situations, corporations organized under tribal law may share the organizing tribe's sovereign immunity from suit. Courts have developed various methods of analysis for determining whether a particular tribally chartered corporation is immune as follows:

- Whether a judgment against the tribal corporation will reach the tribe's assets
- Whether the tribal corporation has the power to bind the tribe's assets or obligate tribal funds
- Whether the tribe and the tribal corporation are closely linked in governing structure and other characteristics, including
- tribal control over appointment and removal of board members
- extent of board's power over the corporation

- Whether federal policies designed to promote tribal self-determination are furthered by extending immunity to the corporation
- Whether the corporation is organized for governmental or commercial purposes
- Whether the corporation holds title to property in its own name
- Whether the entity is legally separate and distinct from the tribe (e.g., as is normally the case with a separately incorporated entity).

As a general rule, the more inter-connected the tribe and the corporation, the more likely a court will be to find that the corporation shares the tribe's immunity from suit. If the entity operates in a manner that is largely independent of the government, it is not likely to be able to cloak itself in governmental immunity.

C. Tax Treatment

While the IRS has consistently ruled that federally recognized tribes and federally-chartered tribal corporations are not subject to federal income tax, it has not charted a clear course with regard to the tax treatment of tribally-chartered corporations. In fact, for the past several years, the Treasury Department and the IRS have listed the federal tax treatment of corporations organized under tribal law as an official "guidance priority," but no guidance has been forthcoming.

D. Disadvantages and Advantages

The advantages of conducting economic development and business activities through a tribally chartered corporation include the following:

- Ease of formation
- Confirmation of tribal sovereignty and freedom from state corporate regulation
- Flexibility (ability to design own governance structure and rules)
- Possible tax immunity
- Possible immunity from suit.

Disadvantages of conducting such activities through a tribally-chartered corporation include the following:

- Uncertainty of federal tax treatment
- Certain business partners may not be comfortable lending to or investing in an entity that is not incorporated under the law of one of the 50 states
- Uncertainty whether the entity would qualify as an issuer in a tax-exempt financing

- Uncertainty whether the tribal corporation will be recognized as sharing the tribe's sovereign immunity.

In sum, a tribally chartered corporation is a flexible entity form that works well in many situations--e.g., where it is intended to operate principally on-reservation as an arm of the tribal government. It would not be the entity of choice for extensive off-reservation activities or as a joint venture entity involving non-tribal parties. The continuing uncertainty surrounding its treatment for federal income tax purposes has diminished its attractiveness for many tribes.

Section 17 Corporation

A. Relationship to Tribal Government

The Indian Reorganization (Wheeler-Howard) Act ("IRA") provided that any tribe or tribes "residing on the same reservation" had the right to organize and adopt a constitution and by-laws which became effective upon a majority vote of the adult members of the tribe and upon approval by the Secretary of the Interior. (Section 16, 25 U.S.C. § 476). The Act also permitted the tribe to incorporate under a charter issued by the Secretary and approved by a majority vote of the members. (Section 17, 25 U.S.C. § 477).³

Specifically, Section 17 provides a means of forming federal corporations allowing tribes to take advantage of the corporate structure and limited liability exposure thereof. Additionally, the provision was intended to allow tribes to assure outside business of its accountability while not waiving immunity to all tribal government assets. "Section 17 was added because of congressional concern that non-Indians would not do business with tribal governments that are immune from suit." William V. Vetter, Doing Business With Indians and the Three 'S'es: Secretarial Approval, Sovereign Immunity, and Subject Matter Jurisdiction, 36 Ariz. L. Rev. 169 (1994).

B. Interplay of Section 17 with Section 16

A tribe organized under Section 16 of the IRA may also be incorporated under Section 17. If a tribe is incorporated under Section 17, it will have a charter issued by the Secretary of the Interior in addition to its constitution under Section 16. However, an Indian tribe organized pursuant to Section 16 of the IRA and an Indian tribe incorporated under Section 17 of the IRA are regarded as two different legal entities even though they may constitute the same Tribe. (Opinion of the Solicitor of the Department of Interior, 1958; Atkinson v. Haldane, 569 P.2d 151 (Alaska 1977)). The Section 16 entity is a political body or governmental entity that possesses sovereign immunity. The Section 17 entity is a business corporation and may lack sovereign

³ Section 17 of the IRA states: The Secretary of the Interior may, upon petition by any tribe, issue a charter of incorporation to such tribe. . . . [S]uch charter may convey to the incorporated tribe the power to purchase, take by gift, or bequest, or otherwise, own, hold, manage, operate, and dispose of property of every description, real and personal, including the power to purchase restricted Indian lands and to issue in exchange therefore interests in corporate property, and such further powers as may be incidental to the conduct of corporate business, not inconsistent with law; but no authority shall be granted to sell, mortgage, or lease for a period exceeding twenty-five years any trust or restricted lands included in the limits of the reservation. Any charter so issued shall not be revoked or surrendered except by Act of Congress. 25 U.S.C. § 477 (1994).

immunity if it has been waived in the charter establishing the business corporation (Maryland Casualty Company v. Citizens Bank of West Hollywood, 361 F.2d 517 (5th Cir. 1966); Cohen's Handbook of Federal Indian Law, 1982). Thus, incorporation creates a separate legal entity with respect to which the powers to contract, to pledge assets, and to be sued may differ from the governmental entity established under the tribal constitution.

In other words, Section 16 of the IRA authorizes tribes to organize a constitutional entity, while Section 17 authorizes organization of a corporate entity. The courts have recognized that these two entities are distinct, and that a consent to suit clause in a corporate charter in no way waives the sovereign immunity of a tribe as a constitutional entity. Seneca-Cayuga Tribe v. Oklahoma, 874 F.2d 705, 715 n.9 (10th Cir. 1989); Ramey Constr. v. Apache Tribe of Mescalero, 673 F.2d 315, 320 (10th Cir. 1982); Kenai Oil & Gas, Inc. v. Department of the Interior, 522 F. Supp. 521 (C.D. Utah 1981), *aff'd and remanded*, 671 F.2d 383 (10th Cir. 1982); Gold v. Confederated Tribes, 478 F. Supp. 190, 196 (D. Ore. 1979); Atkinson v. Haldane, 569 P.2d 151 (Alaska 1977); *but see* Martinez v. Southern Ute Tribe, 150 Colo. 504, 374 P.2d 691 (1962). Further, the Eighth Circuit has held that consent to suit clause in a Section 17 corporate charter does not waive immunity for actions taken pursuant to a tribe's constitution. American Indian Agricultural Credit Consortium v. Standing Rock Sioux Tribe, 780 F.2d 1374, 1379-1380 (8th Cir. 1985).

C. Advantages

The principal reason for incorporation is to address the concern that non-Indian entities would not enter into commercial dealings with the tribal government because of its immunities. 65 Interior Dec. 483, 484 (1958); R. Strickland, et al., Felix Cohen's Handbook of Federal Indian Law 325-326 (1982) (hereinafter 1982 Cohen). Accordingly, charters of incorporation issued under Section 17 of the IRA often contain a clause allowing the corporation to sue or be sued, but this waiver is limited to the business dealings and assets under the control of that corporation and does not extend to the Tribe in its sovereign capacity, as organized under Section 16 of the IRA. 1982 Cohen at 325-326; Kiefer & Kiefer v. RFC, 306 U.S. 381 (1939) (discussing "sue and be sued" clauses applicable to government corporations).

Incorporation allows the tribes to specify under what circumstances sovereign immunity will be waived, because for a waiver to be effective, it must be expressly waived by a tribal entity with the lawful power to do so. If there is no clear or express waiver of immunity, no suit can be brought. The courts have determined that "[i]t is settled law that a waiver of sovereign immunity cannot be implied but must be unequivocally expressed" Santa Clara Pueblo v. Martinez, 436 U.S. 49 (1978). There are two kinds of clear or express waivers that have been found to be effective. The first type of express waiver occurs if the United States Congress or a tribal legislative body enact the waiver into law. United States v. Oregon, 657 F.2d 1009 (9th Cir. 1981); Namekagon Development Co. v. Bois Forte Reservation Housing Authority, 517 F.2d 508 (8th Cir. 1974); Merrion v. Jicarilla Apache Tribe, 455 U.S. 130 (1982); Weeks Construction, Inc. v. Oglala Sioux Housing Authority, 797 F.2d 668 (8th Cir. 1986); American Indian Agricultural Credit Consortium, Inc. v. Standing Rock Sioux Tribe, 780 F.2d 1374 (8th Cir. 1985). The second type of express waiver may be created through an action by an authorized tribal body, the natural consequences of which are binding on the tribe. In regards to Section 17 business corporations, any express waivers of sovereign immunity would be found in the corporation's charter. Hence, the clearly defined waivers would ensure non-Indian entities that remedies would be available in the event of non-compliance, and therefore, such entities would be more attracted to transacting business with tribal corporations.

The federal charter granted to Indian tribes incorporated under Section 17 frequently provides that the corporate entity may "be sued in courts of competent jurisdiction" (Anderson, 1993a). If the corporate charter authorizes the corporate entity to be sued, creditors may bring suit to obtain a judgment and otherwise enforce their lien or contractual rights. However, in such suits only the corporate entity's assets are subject to judgment.

Another advantage to incorporating pursuant to Section 17 is the tax exempt status bestowed upon the participating tribes. In Revenue Ruling 81-295, 1981-2 C.B. 15, the IRS supplemented Revenue Ruling 67-284. The ruling concerned an Indian tribal corporation organized under both sections 16 and 17 of the IRA. It had a constitution and by-laws and a separate corporate charter which organized a federal membership corporation consisting of the present and future members of the tribe. The purpose of the corporation was to conduct communal economic effort to support the tribe's members and to enable the tribe to be self-sufficient. The ruling holds that the corporation shares the tribe's immunity from federal income tax. The ruling quotes a line from the Supreme Court's decision in Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973), as follows: "The question of tax immunity cannot be made to turn on the particular form in which the tribe chooses to conduct its business." *Id.* at 157 n.13. In Revenue Ruling 94-12, 1994-12 I.R.B., however, the IRS *did* use the particular form in which a tribe chooses to conduct business as the determining factor. In that ruling, the IRS confirmed that the business income of Indian tribes doing business under either section 16 or 17 of the IRA, whether earned on or off the reservation, would be exempt. It ruled, however, that income of a tribally-owned state corporation would *not* be exempt.

Note that an IRS General Counsel Memorandum issued in 1982, Gen. Couns. Mem. 38,853 (May 17, 1982), questioned whether off-reservation income of tribes should be taxed, citing the Supreme Court's decision in Mescalero. However, Revenue Ruling 94-12 indicates that the IRS has abandoned this approach in favor of an approach that analyzes the form in which the tribe chooses to do business. Thus, the business income of a tribe, including income of an unincorporated commercial business and income of a corporation under section 17 of the IRA, is exempt whether earned on or off reservation.

The rationale behind Revenue Ruling 67-284 is that Congress never intended to impose income tax on tribal income. Tribes, as sovereign governments, should not be restricted or guided by the income tax laws when they perform sovereign functions. Also, tribes should not be forced to pay income tax in order to provide general revenue funds for the federal government when the tribe would otherwise use the same money to provide local governmental services. In addition, imposition of income tax is inconsistent with federal trust responsibilities and the federal policy of encouraging tribal independence and self-determination. Given these policy considerations, the absence of any code provision expressly imposing income tax on tribes simply reinforces the IRS conclusion concerning the intent of Congress.

As noted above, Revenue Ruling 94-12 holds that income earned from commercial business by a corporation (and perhaps any other legal entity recognized under state law) organized by a tribe under state law is subject to federal income tax, whether earned *on or off* the tribe's reservation. This ruling confirms two private letter rulings issued in 1987, Priv. Ltr. Rul. 88-02-017 (October 9, 1987) and Priv. Ltr. Rul. 88-03-013 (October 19, 1987). The corporations involved in these letter rulings were both state-chartered corporations. The rulings concluded that tribally-owned corporations were subject to federal income tax for off-reservation activities.

As previously stated, an unincorporated Indian tribe or an Indian tribal corporation organized under section 17 of the IRA is not subject to federal income tax on the income earned in the conduct of commercial business on or off the tribe's reservation. In the alternative, a corporation organized by an Indian tribe under state law is subject to federal income tax on the income earned in the conduct of commercial business on and off the tribe's reservation, because as a general rule, a corporation is a legal personality, separate from its owners. Therefore, when a corporation is formed pursuant to state law, a danger exists the tribe may lose the benefit of its Indian tribal status for state tax purposes. The following cases will illustrate how courts address tribal corporations vs. tribal entities incorporated under state law.

1. Eastern Navajo Industries v. New Mexico Bureau of Revenue, 552 P.2d 805 (N.M. 1976). The argument that state taxation of an Indian-controlled state corporation interferes with Indian self-government has been successfully argued in the State of New Mexico. In that case, the tribal council formed a corporation with the help of federal funds from the Indian Business Development Fund. A majority of the stockholders were Indians. The New Mexico Supreme Court said that sales taxes could not be imposed on this corporation, even though it was formed under state law. Under the Indian Business Development Fund Act, a corporation can be considered an Indian corporation if at least 51% of the stock is owned by an Indian tribe or Indians. Since the corporation was an Indian corporation under this act, the court gave it the same tax status as an Indian tribe.
2. United States v. Tax Comm'n of Mississippi, 535 F.2d 300 (1974). In United States v. Tax Comm'n of Mississippi, the federal government brought suit on behalf of the Mississippi Band of Choctaw Indians to enjoin the Mississippi State Tax Commission from imposing a sales tax on a tribal construction company, Chata Development Company, a state-chartered corporation, doing business on the Choctaw Indian Reservation. The Fifth Circuit Court of Appeals upheld the state's tax, resting its decision on two grounds. First, the court held that under the Treaty of Dancing Rabbit Creek, 7 Stat. 333 (1830), the Mississippi Choctaws lost their status as a federally-recognized tribe, their reservation lost its status as an Indian reservation, and the Indians lost their immunity from state regulation. Second, the court noted that a state always has authority to tax state-chartered corporations because they are separate entities from the people who own them.

The validity of these holdings may be undermined altogether by the decision of the United States Supreme Court in United States v. John, 437 U.S. 634 (1978), in which the Supreme Court held that the Mississippi Choctaw Tribe had not lost its status as a federally-recognized tribe living on a federal Indian reservation and organized under the Indian Reorganization Act of 1934. However, at least in Mississippi, this case may still stand for the proposition that a state-chartered corporation, even owned 100% by a federally-recognized Indian tribe, is subject to state tax upon business performed wholly inside the reservation. As you can see, using a state-chartered corporation form is still risky from a tax standpoint because courts in other states may not follow the New Mexico Supreme Court's decision in Eastern Navajo Industries, 552 P.2d 805 (N.M. 1976).

In conclusion, Indian tribes possessing sovereign powers clearly have the authority to charter corporations. There does not appear to be any authority on the question of whether a state can tax a tribally-chartered corporation doing business on the reservation. Significantly, courts usually

look to the law of the government which created the corporation to answer questions about its status. Accordingly, some tribes have enacted tribal corporate codes which provide that tribally-chartered corporations hold the same privileges and immunities from state interference as their stockholders possess. Such laws should be sufficient to stop attempts by states to tax or regulate the on-reservation activities of the corporation, but are not likely to prevent attempts by states to tax or regulate off-reservation activities. Remember that in Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973), the Supreme Court held that whenever an Indian tribe does business off the reservation, its gross receipts are subject to state tax the same as non-Indians. It is likely that the courts would hold that a tribally-chartered corporation, even if 100% tribally owned, possesses no greater tax immunity than the tribe itself.

D. Disadvantages

The disadvantages to incorporating pursuant to Section 17 are few and can be avoided by properly drafted charters, ordinances, etc. First, if the Tribal Council plans on closely managing the business entity, a Section 17 corporation should not be formed, because an inadequate separation of governmental activity from the business entity may lead to problems such as: 1) the inability of creditors of such an enterprise to sue the tribe because of the doctrine of sovereign immunity; and 2) business proposals having to be presented to the elected officials of the tribe which may create difficulty if the elected individuals do not have a business background or if they have their own hidden agendas. For many tribes, the distinction between the corporation and the tribal government has been lost along with its intended benefits. When a tribal corporation and government are not completely distinct, the immunity of the latter extends to the business operations of the former. In addition, corporations formed under tribal law tend to be even more indistinct from the tribe. "In practice, the functions and features of I.R.A. § 16 governments and I.R.A. § 17 corporations were confused and commingled by both federal and tribal officials, to the extent that some tribes' governing bodies are called the Business Committee or Business Council." *citing*, Stock West, Inc. v. Confederated Tribes of Colville Reservation, 873 F.2d 1221 (9th Cir. 1989); Namekagon Development v. Bois Forte Reservation Hous. Auth., 517 F.2d 508 (8th Cir. 1975); Leigh v. Blackfeet Tribe, Fed. Sec. L. Rep. (CCH) ¶ 95,436 (D. Mass. 1990); Kenai Oil & Gas, Inc. v. Department of Interior, 522 F. Supp. 521 (D. Utah 1981); *aff'd and remanded*, 671 F.2d 383 (10th Cir. 1982).

Today it is more difficult to determine if a tribal corporation is immune from suit than it is to evaluate the effectiveness of a tribal government's waiver. Part of the problem is the diversity of tribal organizational forms and the lack of strict organization maintained by tribes. Perhaps the greater problem is the complexity of the law governing whether a tribal business organization shares its creator's immunity. Courts have used a multitude of subtle factors to determine if the corporation is adequately separated from the tribe and therefore not immune to suit. *See, e.g.*, Ramey Constr. Co., Inc. v. Apache Tribe of Mescalero Reservation, 673 F.2d 315 (10th Cir. 1982); Althiemer & Gray v. Sioux Mfg. Corp., 780 F. Supp. 504 (N.D. Ill. 1991), *rev'd on other grounds*, 983 F.2d 803 (7th Cir. 1993); Dixon v. Picopa Constr. Co., 772 P.2d 1104 (Ariz. 1989); Smith Plumbing Co. v. Aetna Cas. & Sur. Co., 720 P.2d 499, *cert. denied*, 479 U.S. 987 (1986); White Mountain Apache Tribe v. Industrial Comm'n of Arizona, 696 P.2d 223 (Ariz. 1985); S. Unique, Ltd. v. Gila River Pima-Maricopa Indian Community, 674 P.2d 1376 (Ariz. Ct. App. 1983), *review denied* (1984); Southwest Forest Industries v. Hupa (Hoopa) Timber Corp., 198 Cal. Rptr. 690 (Ct. App. 1984) (opinion withdrawn by court order); White Mountain Apache Indian Tribe v. Shelly, 480 P.2d 654 (Ariz. 1971); Morgan v. Colorado River Indian Tribe, 443 P.2d 421 (Ariz. 1968). Generally, courts will not even begin to consider whether a Section 17

corporation is exposed to a suit unless the tribe has declared the corporation to be a separate business entity. As the foregoing illustrates, carefully prepared legal documents can dramatically reduce disadvantages associated with incorporating pursuant to Section 17.

State Law Entities

State-law corporations are relatively easy to organize and offer certain advantages. Virtually every state has a statute that permits persons to organize a corporation for business or nonprofit purposes. Distinguishing characteristics of the corporate form of doing business include limited liability for the owners of the corporation, centralized management, transferability of ownership interests (generally in the form of shares of stock), and continuity of life. Since 1994, the IRS has taken the position that a State law corporation, even if wholly owned by a federally recognized tribe, does not share the same federal tax status as the tribe. Because of this unfavorable treatment, many tribes avoid forming state-law corporations--even though they are easily organized and widely recognized by potential business partners and lenders.

A. Relationship to Tribal Government

A state law corporation may be wholly owned and controlled by a tribal government, or it may be owned in part by the tribe and in part by other entities or individuals. A state law corporation will be regulated by the state for corporate law purposes (e.g., compliance with the state's corporate code, fiduciary duty rules, shareholder rights issues). By incorporating under state law, a tribe does not subject the corporation to state regulation for all purposes--particularly with respect to its on-reservation operations. However, a state law corporation going beyond reservation boundaries will be more likely to find itself subject to state regulation than an unincorporated division of the tribe.

B. Sovereign Immunity and Other Liability Issues

State law corporations are unlikely to be able to assert the organizing tribe's sovereign immunity. While state chartered corporations do not appear to be absolutely precluded from sharing in the tribe's sovereign immunity under appropriate circumstances, it is likely that the corporation asserting immunity would need to be primarily, if not exclusively, involved in on-reservation governmental projects. In such situations, under the law of certain jurisdictions, a tribally-owned state chartered corporation might be viewed as an arm of or alter ego of a tribe. But, it appears that as more courts face the issue, organization under state law may be fatal to a finding of entity-level sovereign immunity, particularly for corporations that are structured to limit shareholder liability. The factors relevant to a sovereign immunity analysis of a state law corporation are similar, if not identical to those pertaining to such an analysis of tribal corporation. These factors include:

- Whether the tribe as owner or sole shareholder of the corporation is financially liable for the corporation's legal obligations;
- Whether the corporation's purpose is governmental or commercial;
- The extent and nature of the tribe's control over the corporation; and

- Whether federal policies would be furthered by finding that the corporation shares the tribe's immunity.

In sum, incorporation under state law lessens the chances that a court will treat the tribally-owned business entity as a sovereign "arm of the tribe." While the multi-factor test approach of current law does not preclude treating a state-chartered corporation like a tribal instrumentality with respect to sovereign immunity, the trend cuts against extending immunity to state-incorporated entities. In most cases, organization under tribal law provides a more flexible framework if the tribe wishes to extend its sovereign immunity to a wholly-owned corporation.

C. Tax Considerations

Since 1994, the IRS has taken the position that a state-chartered corporation, even one that is wholly owned by an Indian tribal government and engaged in exclusively on-reservation activities, does not share the same tax status of the tribe.

Subchapter S Corporations

Subchapter S of the Internal Revenue Code treats an "S corporation" as a pass-through entity similar to a partnership. An S corporation must pass through income and loss items separately to its shareholders and thus, as a general rule, the corporation is not subject to a corporate level tax on those items. Subchapter S is only applicable to a "small business corporation," defined as a domestic corporation that does not have more than 75 shareholders. S corporations are not viable options for tribal ownership. Governmental entities are not listed as qualified S corporation shareholders. Moreover, a recent IRS revenue ruling specifically addresses the question of tribal government ownership of S Corporations, and concludes that tribal governments are not qualified S Corporation shareholders under current tax law.

State-Law Limited Liability Companies

An increasingly popular choice of business entity is the limited liability company ("LLC"). An LLC has the advantage of limited liability like a corporation. However, it is generally taxed like a partnership or other "flow-through" entity. If wholly-owned, the LLC may be disregarded as a separate entity for tax purposes. However, a state-chartered LLC--even one that is wholly-owned by a tribe--would likely be treated as a separate legal entity for purposes of legal liability purposes. Thus, it might be difficult (but not impossible) for such an entity to assert tribal sovereign immunity.

A. Tax Considerations

An LLC with a single owner is generally treated as a disregarded entity. As such, it is treated in the same manner as a branch or division of the owner. An LLC with two or more owners is generally treated like a partnership for tax purposes. IRS regulations set forth a number of entities that are per se classified as corporations for federal income tax purposes. This list includes entities referred to as "incorporated" or as a "corporation," "body corporate," or "body politic" under a federal, state or tribal law or statute. This list of per se corporations does not include domestic limited liability companies (LLCs)--other than LLCs wholly owned by a state or foreign government. *See Treas. Reg. §301.7701-2(b)(6)*. Regulations treat LLCs that are wholly owned by a state or foreign government as per se corporations.

B. Advantages and Disadvantages of State-Law Business Entities

The primary advantages of using a state-law business entity includes the following:

- State-law corporations and LLCs are easily and quickly organized
- State-law entities are familiar to lenders and potential business partners
- State-law entities can be effectively used to acquire or merge with an existing state-law entity. In addition, state-law LLC are disregarded for federal income tax purposes when owned by a single member, such as a tribe.

Disadvantages include the following:

- State-law corporations are subject to federal income tax
- State-law entities are not qualified issuer in a tax-exempt financing
- State-law entities are not likely to be regarded as government instrumentalities that are immune from unconsented suit.

For off-reservation ventures, state-law LLCs still have a number of advantages and, from a tax perspective, very few disadvantages.

Limited Liability Companies

The LLC is a type of organization that provides its owners with limited personal liability just like a corporation, but it is not subject to double taxation as regular corporations are. The LLC has become the preferred investment vehicle for investors who want to participate in the management of the entity's business and still limit their personal liability. Under the LLC structure, all of the members obtain the tax advantages of a pass-through entity, but unlike the partnership structure, members can limit their personal liability regardless of whether or not they participate in the management of the LLC's business. Thus, a closely held business that is structured as an LLC is generally able to benefit from certain corporate advantages without jeopardizing its treatment as a partnership for federal income tax purposes.

Partnerships and Limited Partnerships

There are two types of partnerships--general partnerships ("GPs") and limited partnerships ("LPs"). In a GP, each partner of the GP assumes general personal liability for the activities of the partnership. A GP is easily organized, but is not frequently utilized unless the joint venture partners are incorporated or have some form of liability protection. An LP is a partnership with one or more limited partners and at least one general partner. The most popular feature of the LP is the limited liability of the limited partners. The limited partners are protected against personal liability for debts of the partnership that exceed their equity or capital contribution to the partnership. However, in order to retain this limited liability, the limited partners may not participate in the management or control of the partnership's business. Unlike the limited

partners of an LP, the general partners of an LP assume general personal liability for the activities of the partnership.

A. Relationship to Tribal Government

In forming an LLC or LP that is designed to serve as a joint venture with a third party, the tribe should consider whether it would like to own the LLC directly or through an intermediary business entity. Because of the tribe's sovereign immunity and other uncertainties, some potential business partners prefer that the tribe hold its interest through an entity that is legally separate from the tribe. Because of the unfavorable tax treatment, holding a joint venture interest through a state-law corporation is not recommended.

B. Sovereign Immunity and Other Liability Issues

Many of the sovereign immunity and liability issues surrounding tribally owned LLCs and partnerships remain unresolved. Because of the dearth of decided cases, it is unclear whether the sovereign immunity claims of tribal LLCs or LPs will be analyzed similarly to those asserted by tribal corporations or whether a different method of analysis will be used. It is also unclear whether ownership of less than 100% of the entity will be fatal to assertions of immunity from suit. No court has ever held that a business entity that was less than wholly-owned by a tribe can exercise the tribe's immunity. Given this situation, it is safest to assume that the formation of an entity that includes individuals or entities other than the tribe will likely eliminate the connection required to establish that the entity shares the tribe's sovereign immunity.

C. Tax Considerations Applicable to LLCs and LPs

In general, an entity that is a partnership (or an LLC that is taxed like a partnership) is not subject to federal income tax. Rather, each partner (or member in the case of an LLC) includes in its income such partner's allocable share of income, deductions, gains, losses, and credits generated by the partnership. LLCs and LPs combine the tax advantages of a "flow-through" or "pass-through" entity with limited personal liability. An LP is considered a pass-through entity because the partnership itself does not pay tax, but, partnership income is allocated and taxed to the partners, whether or not they receive a distribution of all or any part of such income. Furthermore, the partners may use the losses or credits generated by the partnership to offset their income from other sources. With respect to tribal participation in a partnership, the IRS has stated that a tribe that is a partner in a partnership is not subject to federal income tax. The IRS has cautioned, however, that "a tribally owned state chartered corporation that is a partner [in a partnership] will be subject to federal income tax on its distributive share of partnership income." Sections 301.7701-1 through 301.7701-3 of the Treasury Regulations.

D. Advantages and Disadvantages

Advantages of conducting economic development and business activities through a jointly-owned LLC or LP include the following:

- Ease of formation
- Flexibility (relative ability to design own governance structure)

- Flow-through taxation resulting in tribe's share of joint venture income flowing through free of federal tax to the tribe.

Disadvantages of conducting such activities through a jointly owned LLC or LP include the following:

- Likely loss of sovereign immunity for the joint venture entity
- Inability to qualify for certain types of financing
- Difficulties in unwinding the venture if one party wants to terminate.

Please contact me if there are any questions.