STRUCTURING TRIBAL BUSINESS ENTERPRISES AND JOINT VENTURES

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OVERVIEW - STRUCTURING TRIBAL BUSINESS*

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

CHOICE OF BUSINESS STRUCTURES

• Why is it important?
• Determines how a tribe will interact with non-Indian businesses or partners
• A non-Indian partner needs to know the type of tribal organization
KEY FACTORS TO CONSIDER

- Ease of Formation
- Facilitating Financing for the Venture
- State and Federal Tax Treatment
  - Income Tax Immunity for Tribe
  - Tax Incentives for Project
  - State Sales and Fed/State Excise Taxes
KEY FACTORS TO CONSIDER (continued)

• Protection of Tribal Assets
• Limitation of Liability For Non-Tribal Owners
• Resolution of Disputes (choice of law, forum, etc.)
THREE TYPES OF GOVERNMENTAL ENTITIES

• Tribal Government

• Unincorporated Agencies, Divisions and Instrumentalities of the Tribal Government

• Political Subdivision of Tribal Government
THREE FORMS OF BUSINESS ENTITIES

• Corporation

• Partnership

• Limited Liability Company (LLC)
TRIBAL GOVERNMENT AS A BUSINESS ENTITY

- Tribes have inherent rights of self-government, including the power to engage in business and commercial activities.
- IRS has consistently ruled that the Tribe is not a taxable entity. See Rev. Rul. 94-16
  - Income derived from any business operated directly by a Tribe will be tax free
  - No reservation-boundary limitation
- Tribal Governments also possess sovereign immunity from suit
TRIBAL GOVERNMENT AS A BUSINESS ENTITY

• Federally recognized Indian tribal governments (ITGs) also have some of the same tax benefits as states. See 26 U.S.C. Section 7871
  – Income and estate tax deductibility for charitable contributions/bequests made to the ITG (use limited to public purposes)
  – Tax-exempt bond financing authority (use limited to essential governmental functions)
  – Exemption from various excise taxes (also subject to the essential governmental function test)
UNINCORPORATED AGENCIES, DIVISIONS AND INSTRUMENTALITIES

• Tribe may operate a business tax-free through an agency, unincorporated division, or an instrumentality

• Generally, these governmental units are formed under tribal law for governmental purposes, including economic development (e.g., a tribal utility)

• Share the same legal characteristics of the tribal government because they are generally not separate legal entities
UNINCORPORATED AGENCIES, DIVISIONS AND INSTRUMENTALITIES (Management)

- These governmental units are usually controlled by the tribal government and its tribal council.
- May have a board of directors, which is usually comprised of multiple tribal council members.
- Manager in charge of day-to-day activities.
UNINCORPORATED AGENCIES, DIVISIONS AND INSTRUMENTALITIES
(Immunity)

• Indian tribes possess sovereign immunity from lawsuits
• Governmental units that serve as subordinate economic tribal entities possess the same immunity
• Consequently, these units cannot be sued absent a clear waiver of immunity
• Immunity can create uncertainty and risks for nontribal partners and lenders
UNINCORPORATED AGENCIES, DIVISIONS AND INSTRUMENTALITIES (Tax Treatment)

- IRS has consistently ruled that the Tribe is not a taxable entity. See Rev. Rul. 94-16.
- Tribal governmental units have been treated the same as tribes because they are not a separate legal entities.
- There is no business enterprise wholly-owned by Tribe per se exemption from federal income tax.
- Instead, tribal business enterprises must be operating arms of the Tribe itself.
UNINCORPORATED AGENCIES, DIVISIONS AND INSTRUMENTALITIES
(Tax Treatment continued)

• When determining tax treatment of an instrumentality, the IRS looks at the following:
  – Governmental purpose or function
  – Performance of function on behalf of the tribal government
  – Whether the tribal government has the power and interest of an owner
UNINCORPORATED AGENCIES, DIVISIONS AND INSTRUMENTALITIES
(Tax Treatment continued)

- Control and supervision by tribal government
- Statutory authority for instrumentality
- Degree of financial autonomy and source of operating expenses
PROS AND CONS

• Advantages:
  – Certainty of tax treatment
  – Same federal privileges and immunities as tribe
  – Access to federally subsidized financing (including tax-exempt and/or tax-credit bonds)

• Disadvantages:
  – Governance issues (e.g., mixing business and politics)
  – Requirements of partners and lenders
A political subdivision is a unit of the tribal government that:

- Is separate from the government itself
- Has been delegated a sufficient amount of one or more recognized sovereign powers of the tribe
- Created under tribal law to fulfill a substantial governmental function of the government (e.g., a utility that performs regulatory functions)
- Has same tax-free status as the Tribe
POLITICAL SUBDIVISIONS (continued)

- Tribal political subdivision must exercise one or more sovereign powers:
  - Power to tax
  - Power of eminent domain
  - Power to regulate

- 2-Part determination to confirm status:
  - BIA
  - IRS
POLITICAL SUBDIVISIONS (continued)

- IRS treats political subdivisions the same as the tribe—so long as they qualify as such by having been delegated substantial government powers
- Political subdivision shares in other tax benefits under IRC §7871
  - Tax-exempt bond authority
  - Excise tax exemptions
PROS AND CONS

• Advantages of a political subdivision
  – Relative certainty of federal tax treatment
  – Possible retention of state tax immunity
  – Can use political subdivision as both a regulatory body and as a business holding or operating company
  – Availability of federally subsidized financing, such as Clean Renewable Energy Bonds ("CREBs")
• Disadvantages of a political subdivision
  – Time and expense of formation, including dual federal agency approval
  – Not as flexible as ordinary business entities
  – Business partners may not be comfortable dealing with a governmental entity
TRIBAL BUSINESS CORPORATIONS

• Federal Law Corporations
• State Law Corporations
• Tribal Law Corporations
FEDERAL LAW CORPORATIONS

• Section 17 of Indian Reorganization Act (IRA)
  – Formerly available only to tribes that had elected to organize their government under the IRA
  – Since 1990, available to non-IRA tribes and Alaska Native Communities

• Section 3 of the Oklahoma Indian Welfare Act
• Can be utilized as a holding company for a number of tribal subsidiaries (including an energy business)
SECTION 17 CORPORATION

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

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

• Must be wholly-owned by the tribal government (no private ownership)

• Managed and controlled by a corporate board of directors appointed by the tribal government

• CEO or manager in charge of day-to-day operations
SECTION 17 CORPORATION
(Immunity)

• Corporation vested with the same privileges and immunities as the tribe, including immunity from suit
• Section 17 charter contain a “sue and be sued clause” permitting corporation to be sued in its corporate name
• Sovereign immunity waiver should be limited to corporate sovereign immunity and/or specific transactions that Section 17 corporation is involved in
PROS AND CONS

• Advantages
  – Same tax treatment as Tribe (Rev. Rul. 94-16)
  – Segregates assets and liabilities of business from tribal assets
  – If properly organized, the Corporation is immune from suit, but may waive immunity
  – 25 year leasing authority
    • Section 81 approval not necessary for leases or mortgages of tribal land
PROS AND CONS
(continued)

- Disadvantages
  - Department of Interior (DOI) approval time may be lengthy
  - Once a charter is issued it can only be revoked by Congress
  - Business partners and lenders are unfamiliar with federal chartering (e.g., no accessible DOI database of approved charters)
  - Availability of Financing (e.g., not a qualified issuer of CREBs)
STATE LAW CORPORATIONS

• Corporation formed under state incorporation laws
• May be wholly owned and controlled by tribe, or it may be partially owned by the tribe and partially owned by other entities and individuals
• State law corporation is subject to state corporate law
• Most likely unable to assert tribe’s sovereign immunity
STATE LAW CORPORATIONS (continued)

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

• Advantages of State-law corporations
  – Easily and quickly organized
  – Familiar to lenders and potential business partners
  – May facilitate a merger

• Disadvantages
  – Subject to federal income tax
  – Not a qualified issuer of tax-exempt financing
  – Not likely immune from suit
TRIBAL LAW CORPORATIONS

- Tribal law corporations are formed under a tribe’s corporate code
- Tribal law corporations have been used with increasing frequency
- Relatively easy to establish, as compared to federally chartered corporations
- Tribal law corporations, unlike state law entities, are more likely to be free from state regulation (so long as business operations are confined to reservation)
While the tribe is often the only shareholder, the corporation is managed by its own board of directors. Tribal law corporations are managed and overseen by a corporate board of directors that are elected by the corporation’s shareholders. Directors approve budgets, approve the hiring and firing of setting compensation for senior officials, and establishing a business strategy. A CEO or executive director manages the day-to-day operation.
TRIBAL LAW CORPORATIONS (Tax Treatment)

- Since 1994, income tax status has been uncertain
  - Rev. Rul 94-16 did not address
  - In 1996, classification of entity regulations did not address, but preamble noted that Treasury and IRS were still studying issue.

- In 2001, Treasury/IRS agreed to resolve the uncertainty.
  - Progress on the pending IRS guidance has been slow
TRIBAL LAW CORPORATIONS
(Tax Treatment)

• IRS could take one of three possible approaches
  – Treat like federally-chartered corporation (per se approach)
  – Apply Integral Part test (facts and circumstances)
  – Treat like state chartered corporation (negative per se)
• Integral Part Factors (IRS Version)
  – Whether Tribe has substantial governance control over Entity
  – Whether Tribe has made a significant financial commitment to entity
“Integral Part” test is also used to determine tax treatment of state and local government-owned business entities.

IRS has enlarged pending guidance project to cover all government-owned corporations and changed the form of guidance from a ruling to proposed regulations.

However, while the new proposed regulations are being formulated, the IRS has stopped issuing “integral part” rulings to both tribal government-owned and state government owned corporations.

Thus, tax uncertainty persists.
PROS AND CONS

• Advantages of tribal law corporations
  – Ease of formation
  – Tribal sovereignty and less likelihood of state regulation
  – Flexibility
  – Possible tax immunity
PROS AND CONS (continued)

• Disadvantages
  – Uncertainty of federal tax treatment
  – Business partners may not be comfortable
  – Uncertainty of sovereign immunity
  – Availability of financing
ANOTHER OPTION: LIMITED LIABILITY COMPANY (LLC)

- An increasingly popular choice of business entity
- Commonly used for energy projects
- LLCs provide their owners with limited liability (like a corporation) but are not subject to double taxation
- Generally, formed under state law
- If subject to state law, sovereign immunity may not available
ANOTHER OPTION: LIMITED LIABILITY COMPANY (LLC) (continued)

- Formation requirements are similar to corporations
  - Can be quickly and easily organized under the laws of most states (or a tribal LLC code)
  - Must select a name and file a document similar to a corporation’s Articles of Incorporation
- May be wholly owned and controlled by tribe, or it may be partially owned by the tribe and partially owned by other entities and individuals
LIMITED LIABILITY COMPANY
(Tax Treatment)

• Federal tax treatment of LLCs is provided for under sections 301.7701-1 through 301.7701-3 of the Treasury Regulations (sometimes referred to as the “check-the-box” regulations)
• If owned by two or more members, taxed like a partnership
• If wholly-owned, “disregarded” as a separate legal entity
• May elect to be taxed as a corporation
SINGLE-MEMBER ("SM") LLCs

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

- State-law LLCs limit liability to the assets of the company, thereby protecting the owners or members.

- At least two courts have suggested that a tribe’s sovereign immunity does not extend to its state-law LLC itself.
PROS AND CONS OF LLCs

• Advantages
  – Easily and quickly organized
  – Familiar to lenders and potential business partners
  – Can be used to acquire or merge with an existing state-law entity
  – Private financing available
PROS AND CONS of LLCs (continued)

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

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

• Choice of entity
  – Corporation (generally not tax-efficient)
  – Partnership (flow-through tax treatment)
  – LLC (same as partnership)

• Formation (choice of law)
  – State
  – Tribal
JOINT VENTURES (continued)

- As previously discussed, an LLC can be easily and quickly organized.

- To organize, must select a name and file a document that is similar to a corporation’s Articles of Incorporation.
JOINT VENTURES (continued)

• May form JV as a general or limited partnership

• General partnerships are easily organized (do not even have to file with the state), but each partner assumes liability for the activities of the organization
LIMITED PARTNERSHIPS have one or more limited partners and at least one general partner.

- Limited partners are protected against personal liability for the partnership’s activities.
- Limited partners cannot participate in the management and control of the business.
- General partner assumes liability for the partnership’s business activities.
- General partner manages and controls the business.
JOINT VENTURES (continued)

• Considerations common to LLCs and LPs
  – Whether to own the JV interest directly or through an intermediary business entity
  – Because of the tribe’s sovereign immunity and other uncertainties, business partners may prefer that the tribe hold its interest through a separate business entity
  – Sovereign immunity is not available
  – Can be structured to minimize liability of owners
JOINT VENTURES (continued)

- Considerations common to LLCs and LPs (continued)
  - Unlikely a JV would be able to use a tax-exempt bond offering
  - Types of financing available
    - Government-guaranteed loans
    - Taxable bond issuances?
    - Private placements
    - Commercial bank financing
JOINT VENTURES (Tax Treatment)

• The default classification for a JV with two or more members is to treated as a partnership (check-the-box)

• If a Tribe is a member of a partnership (or an LLC treated as partnership), it will not be taxed on its share of JV’s gross income

• Tribe and JV partner can structure how profits and losses, deductions and tax credits are allocated – within limits
  – Substantial economic effect
  – Tax-exempt entity leasing rules
Pros and Cons

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

- Ease of formation
- Flexibility (relative ability to design own governance structure
- Flow-through taxation, which results in
  - Tribe’s share of the JV’s income being tax free
  - Other partner’s share of tax benefits (e.g., deduction, credits) being available to it
PROS AND CONS (continued)

• Disadvantages
  – Likely loss of sovereign immunity
  – Inability to qualify for certain types financing
  – Difficulties in unwinding the JV if one party wants to terminate
  – Complicated tax rules apply if parties make disproportionate allocations of tax credits or other tax benefits
WHERE DO WE GO FROM HERE?

• Questions and Answers
• Follow-up Contact Information

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• Tribal Business Structure Handbook will be available for purchase at www.___.org/publications.