STRUCTURING TRIBAL BUSINESS ENTERPRISES AND JOINT VENTURES

Tribal Energy Program
Renaissance Hotel
Denver, CO

November 19, 2008

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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

* This PowerPoint Presentation is based on concepts presented and detailed in the Tribal Business Structure Handbook, co-authored by Karen Atkinson and Kathleen Nilles (2008). The Handbook is available for purchase at www. org/publications.

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 <u>some</u> of the same tax benefits as states. <u>See</u> 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 <u>excise</u> 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 posses 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

POLITICAL SUBDIVISIONS

- 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")

PROS AND CONS (continued)

- 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 <u>corporate</u> 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 <u>not</u> 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)

TRIBAL LAW CORPORATIONS (Management)

- 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

TRIBAL LAW CORPORATIONS (Tax Treatment continued)

- “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

JOINT VENTURES (continued)

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

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 – <u>within limits</u>
  - 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.