

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE-MIS No.: TAM-146957-05

Director  
Office of Tax Exempt Bonds

Taxpayer's Name:	
Taxpayer's Address:	
Taxpayer's Identification No	
Year(s) Involved:	
Date of Conference:	

LEGEND:

Tribe =

Issuer =

Bonds =

Date =

x =

City A =

City B =

y =

z =

ISSUE(S):

Is the construction and operation of the Project described below by the Tribe an exercise of an essential governmental function within the meaning of § 7871(e)?

CONCLUSION(S):

The construction and operation of the Project, described below, by the Tribe is not an exercise of an essential governmental function with the meaning of § 7871(e).

FACTS:

The Tribe is listed as an Indian tribal government in Rev. Proc. 2002-64, 2002-2 C.B. 717. On Date, the Issuer issued the Bonds and loaned the Bond proceeds to the Tribe. The Tribe used the Bond proceeds to finance and refinance the planning, design, development, construction, installation, equipping and opening of: (1) a convention facility with an approximately x-room full-service four-diamond quality conference hotel and ancillary facilities on the Tribe's reservation located near City A and (2) a convention facility with an approximately x-room full-service, four-diamond quality, conference hotel and ancillary facilities on the Tribe's reservation located near City B, (together the "Project"). Concurrently with the construction of the Project, the Tribe financed, from sources other than from the proceeds of the tax exempt bonds, the planning, design, development, construction, installation and equipping and opening of: (1) an approximately y square foot gaming facility on the Tribe's reservation located near City A and (2) an approximately z square foot gaming facility on the Tribe's reservation located near City B (together, the "Additional Facilities").

The portion of the Project and the Additional Facilities located at each of City A and City B are operated as an integrated facility. In addition, the Tribe has entered into license agreements with respect to the portions of the Project and the Additional Facilities located at each of City A and City B whereby such portion of the Project and the Additional Facilities located at each of City A and City B will use a licensor's trade name subject to certain restrictions imposed by the licensor designed to ensure certain quality standards commensurate with the brand.

LAW AND ANALYSIS:

Section 7871 sets forth the various purposes for which an Indian tribal government may be treated as a state. The term Indian tribal government is defined under § 7701(a)(40) of the Code to mean the governing body of any tribe, band, community, village or group of Indians, or (if applicable) Alaska Native that is determined by the Secretary of Treasury, after consultation with the Secretary of the Interior, to exercise governmental functions. The Secretary's determination is set forth in Rev. Proc. 2002-64, which contains a modified and supplemented list of Indian tribal governments that are to be treated similarly to states for specified purposes under the Code.

Section 7871(a)(4) provides that subject to § 7871(c), an Indian tribal government shall be treated as a state for purposes of § 103 (relating to state and local bonds). Section 7871(c)(1) states that § 103(a) shall apply to an obligation (not described in § 7871(c)(2)) issued by an Indian tribal government (or a subdivision thereof) only if the obligation is part of an issue substantially all of the proceeds of which are used in the exercise of any essential governmental function.

Section 7871(e) provides that an essential governmental function does not include any function that is not customarily performed by state and local governments with general taxing powers.

We have concluded that under § 7871(a)(4) and § 7871(c) an Indian tribal government may be treated as a governmental unit for purposes of § 103(a) only if the proceeds of the Bonds are to be used in the exercise of an essential governmental function within the meaning of § 7871(e). Whether the proceeds of the Bonds could be used to finance the Project depends upon whether ownership and operation of the Project is an exercise of an essential governmental function which depends, in part, on whether such activity is customarily performed by state and local governments with general taxing powers.

Section 7871(c)(1) does not define the term essential governmental function. A definition was put forward in Temporary Income Tax Regulation § 301.7871-1, which applied only to bonds issued before January 1, 1987. The regulation defined an essential governmental function for purposes of § 7871 as "a function of a type which is: (1) eligible for funding under 25 U.S.C. 13 and the regulations thereunder; (2) eligible for grants or contracts under 25 U.S.C. 450(f), (g), and (g) and the regulations thereunder; or (3) an essential governmental function under section 115 and the regulations thereunder when conducted by a State or political subdivision thereof." However, this definition was specifically rejected by Congress as too liberal when § 7871(e) was enacted. In the absence of a statutory or regulatory definition of the term "essential governmental function", we turn to the legislative history of § 7871 to determine the intent of Congress with respect to tax exempt financing by Indian tribal governments.

The essential governmental function limitation has been in place since the original enactment of § 7871 as a temporary provision of the Code by The Indian Tribal

Government Tax Status Act, Pub. L. No. 97-473, 96 Stat. 2605 §202 (1983). The Report of the Senate Finance Committee, explains:

The bill provides that Indian tribal governments are to be treated generally the same as states (and tribal subdivisions are to be treated generally the same as political subdivisions of states) for purposes of the tax-exempt bond interest provisions. However, the bill includes a number of restrictions on this treatment of Indian tribal governments with respect to commercial or industrial activities or other activities other than essential governmental functions. The purpose of those restrictions is generally either (1) to allow the profits from such activities to be exempt from federal income tax (because of the basic federal income tax exemption of Indian tribes and because Section 115 does not apply to Indian tribes) or (2) to allow the interest on the obligations where the proceeds are used in such commercial or industrial activities to be exempt from federal income tax, but not to allow both of these benefits to apply in any one case. . . .

If all of a major portion of the proceeds of an Indian tribal government obligations are to be used, directly, or indirectly, in one or more commercial or industrial activities (or other activities other than essential governmental functions) conducted by the tribe then the interest on the obligation is not to be exempt from federal income tax.

In October of 1987, the House of Representatives was concerned with the expansive definition of essential governmental function included in the Temporary Regulations and introduced § 7871(e) as part of The Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, 101 Stat. 1330, §10632(a) (1987). The House Report explains this provision as follows:

The bill clarifies that, with respect to bonds issued by Indian tribal governments, the term essential governmental function does not include any governmental function that is not customarily performed (and financed with governmental tax-exempt bonds) by States and local governments with general taxing powers. For example, the issuance of bonds to finance commercial or industrial facilities (e.g., private rental housing, cement factories, or mirror factories) which bonds technically may not be private activity bonds is not included within the scope of the essential governmental exception.

Additionally, the committee wishes to stress that only those activities that are customarily financed with governmental bonds (e.g., schools, roads, governmental buildings, etc.) are intended to be within the scope of this exception, notwithstanding that isolated

instances of a State or local government issuing bonds for another activity may occur. Further, the fact that the Bureau of Indian Affairs may provide Federal assistance for Indian tribal governments to engage in commercial and industrial ventures as tribal government activities is not intended to be determinative for purposes of the Internal Revenue Code. (Any existing Treasury Department regulations that may infer a contrary result are to be treated as invalid.)

H.R. Rep. No. 100-391, at 1139 (1987).

The Conference Report to the 1987 Act provides:

The Conference agreement follows the House bill with a modification permitting Indian tribal governments to issue as tax-exempt private activity bonds certain bonds for tribal manufacturing facilities [5] as an exception to the general rule that tribal governments may issue tax-exempt bonds only for essential governmental functions which States and local governments customarily perform. The conferees adopted this limited exception in recognition of the unique responsibilities of Indian tribal governments in managing historical tribal resources and land held in trust by the Federal Government and limited its scope to bonds designed to foster employment opportunities on these tribal lands as part of the performance of this unique responsibility.

H.R. Rep. No. 100-495, at 1012 (1987) (Conf. Rep.).

Footnote 5 to the Conference Report provides:

A facility which does not qualify as a manufacturing facility for purposes of this provision may nonetheless be financed with tax-exempt bonds issued by a tribal government provided that the facility satisfies the 'essential governmental function' standards (i.e., the facility is comparable to facilities that [are] customarily acquired or constructed and operated by States and local governments.) For example, a building used for offices for a tribal government itself would be comparable to State or local government office buildings, and therefore, could be financed with tax-exempt bonds. As another example, a lodge owned and operated by a tribal government may be eligible for tax-exempt financing if it is comparable to lodges customarily owned and operated by State park or recreation agencies.

H.R. Rep. No. 100-495, at 1012 n. 5 (1987) (Conf. Rep.).

Under the specific language of § 7871(e), an activity must be customarily performed by State and local governments to be eligible to be an essential governmental function. The term customary has been defined as “according to or depending on custom; usual; habitual . . . defined by long-continued practices.”<sup>1</sup> In applying this definition to § 7871(e), we look both to the prevalence of such activity among state and local governments as well as the history of state and local governments performing a specific activity. This approach is consistent with the legislative history of §7871, which says that to find that something is customarily performed requires more than “isolated instances” of comparable activity. In addition, the legislative history indicates that comparability requires a comparison beyond the same general activity. As highlighted by the example in footnote 5 to the 1987 House Conference Report, it is not enough that a lodge owned and operated by an Indian tribal government accept paying guests for overnight stays in private rooms like a state owned lodge; instead the lodge must be comparable in other dimensions as well, such as size and amenities. Finally, the 1987 House Report and the 1987 Conference Report indicate that Congress viewed activities customarily conducted by State and local governments as including public works style projects and excluding commercial and industrial activities such as manufacturing facilities. Congress further reflected this understanding by creating a special exception to the private activity bond rules for certain tribally owned manufacturing facilities

Based upon the language of the statute, the legislative history of § 7871 in general and § 7871(e) in particular, we conclude that an activity is to be considered an essential governmental function customarily performed by state and local governments only if: (1) there are numerous State and local governments with general taxing powers that have been conducting the activity and financing it with tax-exempt governmental bonds, (2) State and local governments with general taxing powers have been conducting the activity and financing it with tax-exempt governmental bonds for many years and (3) the activity is not a commercial or industrial activity. For purposes of applying this analysis where the activity is the ownership and operation of a facility, only comparable facilities owned and operated by states and local governments will be taken into account.

With respect to the Project, the Tribe has presented evidence that over the period beginning in 1995 State and local governments used tax exempt bonds to finance 15 large, urban, hotels connected to convention centers and has argued that dozens of additional municipal hotel projects have been considered and are in various stages of development. Although hotels of this type may be comparable to the Project based on size, location, and amenities, based on the information presented by the Tribe, we do not find ownership and operation of such large urban facilities to be either sufficiently prevalent or sufficiently longstanding among state and local governments to be considered an essential governmental function customarily performed by State and

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<sup>1</sup> See Webster's Encyclopedic Unabridged Dictionary of the English Language, (1996) definition of “customary”

local governments. Nor is the Project comparable to lodges customarily owned and operated by state park or recreation agencies. The Tribe has provided information showing that it is common for state park systems to contain full hotel-style lodges each with, on average, 55 guest rooms. Although, the Tribe observes that there are a small number of state park lodges with considerably more guest rooms, very few approach the size and amenities of the Project. Accordingly, we do not find the Project comparable to such state park lodges.

The Tribe argues that economic development activities have been considered essential governmental functions under § 115 of the Code. We acknowledge the broad definition afforded the term essential governmental function in the context of § 115 of the Code. Nevertheless, we are bound to apply § 7871(e) when determining whether or not the Project is an essential governmental function. What constitutes an essential governmental function is necessarily narrower for these purposes than in § 115 in that it requires the activity to be customarily conducted by other State and local governments.

Because ownership and operation of facilities comparable to the Project by state and local governments is not sufficiently prevalent or longstanding, we conclude that the ownership and operation of the Project by the Tribe is not an exercise of an essential governmental function customarily performed by state and local governments within the meaning of §7871(c) & (e).

Because we have determined that ownership and operation of the Project is not an exercise of an essential governmental function based upon the failure of the Project to satisfy the criteria of prevalence and duration among state and local governments described above, we need not also determine whether the ownership and operation of the Project is a commercial activity. However, the facts in this case tend to show that ownership and operation of the Project by the Tribe is a commercial activity for purposes of § 7871(c) and (e). The legislative history to § 7871 does not define the criteria for identifying a commercial or industrial facility but it does provide that "commercial or industrial facilities (e.g., private rental housing, cement factories, or mirror factories) ... [are] not included within the scope of the essential governmental function exception." H.R. Rep. No. 100-391, at 1139 (1987). Similarly, the purposes of an organization exempt under § 501(c)(3), which must serve a broad public interest, cannot include commercial purposes that serve the private interest of those who profit. The legislative history to § 7871 indicates Congress was making a comparable distinction between a broader public interest and an interest in profit when it distinguished an essential governmental function from a commercial or industrial activity.

In the context of determining whether an organization is an exempt organization under § 501(c)(3) several courts have considered whether an organization was operating for commercial rather than exempt purposes. They have consistently treated this as a question of fact. In B.S.W. Group v. Commissioner 70 T.C. 352 (1978), the Tax Court held that a consulting firm that served exclusively nonprofit clients and

charged them fees set at cost was nonetheless a business and was not operated exclusively for charitable purposes. The Court said that “factors such as the particular manner in which an organization’s activities are conducted, the commercial hue of those activities, and the existence and amount of annual or accumulated profits are relevant evidence....” in determining whether the organization has a predominantly commercial purpose. Id. at 358. It further stated that “competition with commercial firms is strong evidence of the predominance of nonexempt commercial purposes.” Id. Similarly, the Eighth Circuit Court of Appeals in Federation Pharmacy Services v. Commissioner, 625 F.2d 804 (8<sup>th</sup> Cir. 1980), focused on the fact that the entity was charging prices at or above cost and operating in competition with for-profit entities in concluding that a pharmacy that offered discounts to senior citizens and disabled people did not operate exclusively for charitable purposes. In Iowa State University of Science and Technology v. U.S., 205 Ct. Cl. 339 (1974), the Court of Claims held that operation of television stations was an unrelated trade or business for the university because the station emphasized revenues, had a steady history of substantial profits, and operated in a commercial manner as reflected through programming policies. See also, Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7<sup>th</sup> Cir. 1991) (Vegetarian restaurant operated by church in direct competition with other restaurants was not operated for exempt purposes even though the restaurant did not earn a net profit); Christian Manner International v. Commissioner, 71 T.C. 661 (1979) (Publication and sale of religious books at a profit served a commercial purpose).

As the courts did in these exempt organization matters, we look to all the facts and circumstances in determining whether the operations of a facility are commercial or industrial in nature for purposes of § 7871(c) and (e). Relevant factors include, but are not limited to whether the facility operates to earn a profit, competes with for-profit entities, and functions in a commercial manner. We also look at the balance of the operations of the facility between service to the local community and attraction of paying customers from outside the local community.

The Project has characteristics of a commercial facility in that it competes with similar commercial businesses located in the same area, and its manner of operation is consistent with commercial operations. Indeed, the hotel is operating under a licensing agreement with a company that ensures operations are consistent with the operations of other hotels, at least some of which are commercial enterprises, using the same trade name.

The Tribe asserts that the Project will be operated at a loss. Although failure to earn a profit is relevant when we are determining whether an activity is commercial, the fact that an activity is operated at a loss, by itself, is not determinative, especially where the other factors discussed above are present. See Living Faith, Inc. v. Commissioner, 950 F.2d 365 (7<sup>th</sup> Cir. 1991). Moreover, the record indicates that the Project was constructed simultaneously with the Additional Facilities, which are located contiguous to the Project at the respective locations, and which are operated together with the Project in integrated operations. The Project and the Additional Facilities when



considered together are expected to earn a profit. The presence of these factors indicate that ownership and operation of the Project is a commercial activity, distinguishable from public works projects such as roads, schools, or governmental courthouse buildings which lack a profit-making objective, which focus on public benefits to local citizens, and which do not compete with other businesses.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.