

INTERNAL REVENUE SERVICE

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7871.00-00

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Date: November 25, 1998

Legend:

Tribe =

State =

Entity =

Property =

Dear :

This ruling responds to your letter dated September 19, 1997, and subsequent correspondence, requesting a ruling that 1) the management of Property by Entity constitutes an essential governmental function of Tribe within the meaning of § 7871(e) of the Internal Revenue Code; and 2) Entity's purchase of diesel and gasoline fuels for use in the management of Property is exempt from excise taxes imposed under § 4081(a).

FACTS

Tribe is included on the list of tribal entities published by the Secretary of the Interior in the Federal Register. See 62 Fed. Reg. 55270, 55272 (1997). Tribe has also been recognized as an Indian tribal government for purposes of § 7871 of the Code in Rev. Proc. 83-87, 1983-2 C.B. 606, 608. Tribe formed a state chartered corporation (Corporation) to manage certain tribal lands (Property). Subsequently, Tribe and the federal government entered into several written agreements, including a management plan (Plan) and a trust and management agreement (Trust). At that time the functions of Corporation were taken over by Entity, an organization created pursuant to Plan. Entity serves as the principal business arm of Tribe. The primary function of Entity is to use and manage Property, and to manufacture, market, sell, and distribute certain products. Entity's powers, obligations and responsibilities are set forth

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in Plan. The Tribal Constitution also includes provisions for the operation of Entity.

Entity is governed by a board of twelve directors elected by the members of Tribe. Board members can be recalled by either the Tribal Legislature or the eligible voters of the Tribe. According to Plan, the directors of Entity have all powers consistent with the powers of directors of business corporations. Plan allows the Board to take such further actions as are commonly engaged in by corporate bodies, as the board of directors may deem reasonably necessary to effectuate the purposes of the Entity enterprise. Pursuant to Plan, Tribe gives its consent to allow Entity to sue or be sued. However, Plan provides that, except as specifically provided, Plan shall not operate as a partial or total waiver of the sovereign immunity of Tribe.

The Tribal Legislature has the power to establish a successor business to succeed Entity by adopting a written charter for the successor organization.

Entity has no interest in any tribal real property except for the right to manage and operate the facilities in the manner set forth in Plan. No tribal real property can become an asset of Entity for any purpose.

Entity is treated differently than other businesses operated by Tribe. Although Tribe's other business ventures are required by its Constitution to make regular reports on the financial status of such tribal business to the Tribal Legislature, this requirement does not apply to Entity. However, Entity is subject to an audit by an independent certified accounting firm at the end of each year.

Profits for the year are divided between the Tribe and Entity by the board of directors of Entity. In making the division between the share retained by Entity and Tribe's share, the board is required to consult with the Tribal Legislature, and to be guided by industry standards. The Tribe's share is, thereafter, allocated by the Tribal Legislature for use in tribal operations or for distribution to members of Tribe after considering the need for effective tribal operations and the individual financial needs of tribal members.

Tribe is required to make an annual determination as to whether Entity is being operated according to its charter documents. Each such determination by Tribe must be submitted to the Secretary of the Interior for review. His concurrence is deemed to have been given unless, within 60 days of receipt

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thereof, the Secretary finds that such determination was without rational basis. The Secretary has no authority in regard to the management of the tribal business, except as specifically provided in Trust.

RULINGS REQUESTED

1. Is Entity an integral part of Tribe?
2. Does management of Property by Entity constitute an essential government function of Tribe within the meaning of § 7871?
3. Is Entity exempt from fuel excise taxes imposed under § 4081(a). and by §§ 4084(2) and 6421(c) for gasoline and by §§ 4084(3) and 6427(1) for diesel fuel when the gasoline and diesel fuel are used to manage Property.

LAW

An Indian tribe is not exempt from federal excise tax, absent an express exemption in the Internal Revenue Code. Confederated Tribes of Warm Spring v. Kurtz, 691 F.2d 878 (9th Cir. 1982), cert. den., 460 U.S. 1040 (1983); Rev. Rul. 94-81, 1994-2 C.B. 412.

Section 7871(a) of the Code treats an Indian tribal government as a state for certain federal tax purposes. Section 7871(a)(2) of the Code provides that an Indian tribal government shall be treated as a state for purposes of any exemption from certain excise taxes, including those imposed by chapter 31 (relating to tax on special fuels) and chapter 32 (relating to manufacturers excise taxes).

Section 7871(b) of the Code provides that § 7871(a)(2) will apply with respect to a transaction only if, in addition to any other requirement applicable to similar transactions involving a state or political subdivision, the transaction involves the exercise of an essential governmental function of the Indian tribal government.

Section 7871(e) of the Code, which was added to the Code by section 10632 of the Revenue Act of 1987, Pub. L. No. 100-203, provides that for purposes of § 7871, the term "essential governmental function" will not include any function which is not customarily performed by state or local governments with general taxing powers.

Rev. Rul. 94-81, 1994-2 C.B. 412, provides examples that illustrate the application of federal excise taxes to Indian

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tribal governments. According to the ruling, gasoline wholesale distributors and diesel fuel ultimate vendors may sell gasoline and diesel fuel to the tribal governments tax free for the purpose of providing schools, police, or firefighting services because providing school, police, or firefighting services is an essential governmental function within the meaning of § 7871. However, there is no exemption that would allow a state or an Indian tribal government to purchase fuel tax free for the purpose of reselling the fuel to consumers. An Indian tribal government is also subject to a manufacturer's excise tax imposed by § 4161 when it manufactures and sells archery and sport fishing equipment to a sporting goods company.

Section 301.7701-1 et seq. of the Procedure and Administration Regulations supports the position that an entity that is separate from a state or political subdivision may, nonetheless, be an integral part of that state or political subdivision. Section 301.7701-1(a)(3) provides, in part, that:

An entity formed under local law is not always recognized as a separate entity for federal tax purposes. For example, an organization wholly owned by a State is not recognized as a separate entity for federal tax purposes if it is an integral part of the State. Similarly, tribes incorporated under section 17 of the Indian Reorganization Act of 1934, as amended, 25 U.S.C. 477, or under section 3 of the Oklahoma Indian Welfare Act, as amended, 25 U.S.C. 503, are not recognized as separate entities for federal tax purposes.

If an enterprise is deemed to be an integral part of a state or political subdivision of a state, that enterprise will not be treated as a separate entity for federal tax purposes, regardless of the fact that the enterprise was created as a separate entity. § 301.7701-1(a)(3). See, also, Rev. Rul. 81-295, 1981-2 C.B. 15.

In Maryland Savings-Share Insurance Corp. v. United States, 308 F. Supp. 761, rev'd on other grounds, 400 U.S. 4 (1970) ("MSSIC"), the State of Maryland formed a corporation to insure the customer accounts of state chartered savings and loan associations. Under MSSIC's charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Only three of eleven directors were selected by state officials. The district court rejected MSSIC's claim of intergovernmental tax immunity because the state made no financial contribution to MSSIC and had no present interest in the income of MSSIC. Thus, the imposition of an income tax on MSSIC would not burden the State of Maryland. Although the Supreme Court reversed the lower court on other grounds, it agreed with the lower court's analysis about the treatment of state created enterprises.

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In State of Michigan and Michigan Education Trust v. United States, 40 F.3d 817 (6th Cir. 1994), rev'g 802 F. Supp. 120 (W.D. Mich. 1992), the court held that the investment income of the Michigan Education Trust (MET) was not subject to current taxation under § 11(a). The court's opinion is internally inconsistent because it concludes that MET qualifies as a political subdivision of the State of Michigan (Id. at 825), that MET is "in a broad sense" a municipal corporation (Id. at 826), and that MET is in any event an integral part of the State of Michigan (Id. at 829). Moreover, the court's reliance on the factors listed in Rev. Rul. 57-128, 1957-1 C.B. 311, to reach its conclusion is misplaced. The revenue ruling applies to entities that are separate from the state. The factors in the revenue ruling do not determine whether an enterprise is considered to be a separate entity or an integral part of the state.

In determining whether an enterprise is an integral part of the state, it is necessary to consider all of the facts and circumstances, including the state's degree of control over the enterprise and the state's financial commitment to the enterprise.

#### ANALYSIS

Issue 1: Is Entity an integral part of Tribe?

Entity resembles an enterprise separate from the Tribe in some respects. According to sections 3 and 4(r) of Plan, the powers of the board of directors of Entity are similar to those of a corporation. Entity is also similar to a corporation in that the Tribal Constitution allows Tribe to waive the sovereign immunity of Entity with respect to a specific transaction without waiving the sovereign immunity of Tribe. Tribal Constitution Article XII (c); Plan Section 11. However, the relationship between Entity and Tribe with respect to the creation, control, and termination of Entity, suggests that Entity is an integral part of Tribe.

Of primary importance is the fact that Tribe, including the Tribal legislature, has substantial control over Entity. Although Entity, not the Tribal Legislature, is charged with operating the business on a day-to-day basis, in cases of major policy disputes the Tribal legislature can recall Entity's directors, terminate the existence of Entity and create a written charter for a successor business entity. In addition, it can revise and amend Plan and Trust. It is true that even after creating a successor entity or recalling the directors on the board of Entity under Article XII of the Tribal constitution, the Tribal Legislature cannot select the new directors. They are chosen by the members of Tribe. Further, Article XII section 2(b) of the Constitution

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bars Tribal Legislature from taking upon itself the day to day management of the tribal forest business. Nevertheless, Tribe, whether through the power of Tribal legislature to recall the directors or replace tribal Entity with a successor entity with a new charter, or through the power of individual members of Tribe to vote for the directors of the board of Entity, wields virtually total control of Entity.

That Entity is an integral part of Tribe is confirmed by the nature of its financial arrangements. Tribe's financial commitments to Entity are consistent with a public ownership interest. Tribe has a substantial financial stake in Entity in that Tribe is the owner of the property that Entity manages, and on which it operates its logging and saw mill business. In addition, it has a substantial right to the profits earned by the businesses Entity operates. The profit rights are subject to the limitation that Entity may retain amounts it considers necessary for expansion of the business. However, Entity must consult the tribal legislature and be guided by industry standards when making this decision. There are no private ownership interests in Entity. Nor are there any other private interests inconsistent with its public nature.

Accordingly, we conclude that Entity is an integral part of Tribe. Therefore, for purposes of § 7871, Entity's activities are deemed to be performed directly by Tribe.

ISSUE 2: Does management of Property by Entity constitute an essential government function of Tribe within the meaning of § 7871?

Some of the functions of Entity would, if carried out by Tribe, be considered an essential government function of Tribe for purposes of § 7871 because they are customarily performed by state or local governments. For example, Entity manages and develops the forestland of Tribe, including its natural and physical resources. Many states manage state owned forests and parkland. On the other hand, some of the functions performed by Entity are clearly beyond the scope of § 7871(e) because they are not commonly performed by state or local governments. For example, Entity not only manages forestland, but also harvests and processes the timber. Tribe acknowledges that states rarely harvest or process timber.

Entity carries out commercial logging operations, operates a sawmill, and manufactures and markets timber products. These functions are not customarily performed by state and local governments. Certainly, some aspects of commercial logging operations may overlap conservation. Nevertheless, logging,

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milling and manufacturing functions performed by Entity are enterprises beyond the scope of § 7871(e).

Accordingly, the management of Property by Entity includes functions which would not, if directly carried out by Tribe, constitute an essential government function customarily performed by state and local governments.

ISSUE 3: Is Entity exempt from fuel excise taxes imposed under § 4081(a), by §§ 4084(2) and 6421(c) for gasoline and by §§ 4084(3) and 6427(1) for diesel fuel when the gasoline and diesel fuel are used to manage Property?

Entity's purchases of diesel and gasoline fuels are transactions that involve the exercise of essential governmental functions under § 7871(b) and (e) to the extent that purchases are for use in the management of Property for the purpose of conservation. These activities are comparable to those activities of a state agency that manages and develops parklands. The purchases of diesel and gasoline fuels are not transactions that involve the exercise of essential governmental functions to the extent that the purchases are for use in the harvesting and processing of timber, for the operation of a saw mill, for the operation of a commercial logging business or for the manufacture of timber products. These functions are not comparable to those customarily performed by state and local governments.

Accordingly, Entity is not exempt from the payment of excise taxes on the purchase of gasoline and diesel fuels that are used to harvest and process timber, on its sale and delivery, and the operation of its sawmill. Entity is not required to pay excise tax for gasoline and fuel purchases used to manage Property for non-business purposes such as conservation.

Except as specifically state above, no opinion is expressed concerning this transaction under any provision of the Code or regulations thereunder.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Assistant Chief Counsel

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(Financial Institutions & Products)

By: Steven R. Glickstein  
Steven R. Glickstein  
Counsel to Assistant Chief Counsel

Enclosures:

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