

## BRIEFING PAPER

Date: June 27, 2011

To: Deputy Assistant Secretary Aaron Klein  
Department of Treasury

From: Jacqueline Johnson Pata, Executive Director  
National Congress of American Indians

**Re: IRS Audits and Tribal Government Programs**

In preparation for our upcoming meeting with Tax Policy and Economic Policy officials at the Department of Treasury and IRS administrators and counsel, we thought it would be helpful to provide you with some general background on recent IRS audits of Indian tribal governments and their members that have focused on various types of social welfare programs sponsored by Indian tribal governments. In preparing this briefing paper, NCAI has consulted extensively with a national law firm that is representing several of the Indian tribal government in these IRS audits (many of which have already been resolved, but only through the payment of several millions of dollars in taxes and penalties). The purpose of this briefing paper and our meeting is not to invite reconsideration of any particular IRS enforcement action, but rather to initiate a dialogue in which the legitimate concerns of Indian tribal leaders can be raised.

This briefing paper considers the following:

- What types of tribal governmental programs is the IRS focusing on?
- What types of information is the IRS requesting that tribal government furnish with respect to such health and welfare programs?
- What is the underlying premise of the IRS' examinations of tribal government health and welfare programs?
- Why aren't such government programs simply exempt from tax under the general welfare doctrine?
- Why is this a problem primarily for tribal governments, and not state and local governments?
- What are the primary concerns of tribal leaders regarding the examinations?
- Has the IRS given tribal governments fair notice of its legal positions through the promulgation of generally applicable guidance?

### **Types of Tribal Government Programs that IRS is Examining**

In the various IRS examinations initiated over the past five to seven years, the IRS has examined and/or asserted tax liabilities with respect to the following types of tribal government programs:

- Health Care Programs
- Educational Programs
- Housing Programs
- Loan Programs
- Emergency Assistance
- Cultural Events and Community Activities (e.g., pow-wows)
- Cultural Travel
- Elder Programs (including meals, social events and utility assistance)
- Legal Aid

Following passage of new Code Section 139D (exclusion from income of health benefits provided by Indian tribes to their members) as part of the Patient Protection and Affordable Care Act, the IRS dropped its assertion of tax liabilities and penalties with respect to tribal health programs.

### **Types of Information that the IRS is Requesting Regarding Tribal Programs**

In these IRS examinations, the IRS reviews financial records regarding tribal budgetary expenditures on the above programs and typically asks the Tribe to furnish the following additional documentation:

- Tribal council resolutions, ordinances or meeting minutes showing the establishment, modification, or termination of the programs/benefits
- Any communications to Tribal members describing Tribal benefits, eligibility requirements and/or Federal tax reporting or taxability of benefits
- Written program/benefit descriptions including eligibility requirements.

### **Why Aren't These Government Payments Exempt from Tax?**

The IRS generally starts from the proposition (citing Tax Code Section 61(a) and the applicable Treasury Regulations) that gross income means all income (including in-kind benefits) from whatever source derived, unless excluded by a specific statutory or treaty provision. Although Code Section 61 is very broad, the IRS does exclude certain government payments and benefits under the General Welfare Doctrine. This doctrine

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is used to exempt from federal income taxation payments made by a governmental unit to, or for the benefit of, individuals that promote the general welfare.

The IRS generally focuses on the following three factors when considering whether a payment is excluded pursuant to the General Welfare Doctrine:

- (1) Was it made by a governmental unit?
- (2) Was it for the promotion of general welfare?
- (3) There were no services rendered for such payment.

See Field Service Advice from Assistant Chief Counsel (Income Tax & Accounting) to Group Manager 1436 dated May 15, 1998 (comparing Rev. Rul. 76-131, 1976-1 CB 16, with Rev. Rul. 76-395, 1976-2 CB 16).

The second requirement--that the payment be made to promote the general welfare--has received the most attention. In the past, the IRS has found a large variety of government programs to be "for the promotion of general welfare." Programs that met health needs, educational needs, job training needs, economic development needs, and several other needs were determined to be for the promotion of general welfare. For example, in Revenue Ruling 70-341, 1971-2 CB 3, the IRS ruled that government-provided health care benefits for the elderly, commonly known as Medicare benefits, were not taxable to recipients because the Medicare program furthered the social welfare objectives of the federal government. Furthermore, even in Revenue Ruling 76-131, an adverse ruling that the dividends paid to citizens from State of Alaska's Longevity Bonus program were not eligible for exclusion under the general welfare doctrine, the IRS' reasoning was fairly flexible: Alaska's cash payments were not excludable because they were made to all state citizens that satisfied its age and residency requirements "regardless of financial status, health, educational background or employment status."

However, in recent years, the IRS has narrowed the General Welfare Doctrine standard so that government programs not based on "individualized determinations" of need fail to meet its requirements. See Internal Revenue Manual 4.88.1.7.1(6) (stating "A key consideration is that the general welfare doctrine requires an individual to establish need."). ITG field agents have also interpreted "need" to mean primarily "financial need"---so that if the recipient is someone with an income exceeding the national median family income, any government welfare benefits they receive would be subject to income tax. See Private Letter Ruling 200409033 (Feb. 27, 2004). The only exception to this trend is where the recipient is the victim of a natural disaster.

The staff of the Joint Committee on Taxation has noted the recently shifting standard stating, "[r]ecent [IRS] guidance as to whether the need of the recipient (taken into account under the second requirement of the general welfare exclusion) must be based solely on financial means or whether the need can be based on a variety of other

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considerations including health, educational background, or employment status, has been mixed." See Joint Committee on Taxation, "Technical Explanation of the Revenue Provisions Contained in H.R. 3962, the Affordable Health Care for America Act," p. 58, note 160 (JCX-47-09: November 5, 2009).

**Differential Impact of IRS Audits on Tribal Governments**

While IRS strives to treat all governments the same, a review of the IRS's 2011 Work Plans indicates that some notable differences remain. The IRS's 2011 Indian Tribal Government Work Plan states that one of its primary focus areas is reviewing the taxability of tribal member distributions. Yet, in the IRS's 2011 Work Plan for Federal, State and Local Governments, the taxability of "benefits" provided by State and local governments is not even mentioned.

Indian Tribal Governments may use a different model for delivering their services, but the services provided are not any more numerous or altogether unlike those provided by state and local governments.

For example, City of Alexandria, Virginia ("Alexandria"), had a per capita income of \$72,636 for fiscal year 2011, one of the highest in the United States.<sup>1</sup> For fiscal year 2011, Alexandria approved a budget of almost \$19 million for its recreation, parks and cultural activities.<sup>2</sup> Alexandria uses those funds to provide an almost endless buffet of educational, recreational, and cultural programs for its citizens, as well as housing and health benefits. Attachment A shows a partial list of classes and programs that Alexandria residents can participate in this summer. To our knowledge, Alexandria residents receiving the benefits are not taxed on the benefits' value and the City does not issue 1099s or withhold tax.

However, when Tribal governments provide similar benefits to their tribal members, the IRS has frequently taken the position that those benefits are not only taxable but are subject to withholding under Code Section 3402(r) as "deemed" or "constructive" per capita payments (see Attachment B for a Brief History of Code Section 3402(r)). The IRS maintains that if any tribal program payment or benefit is taxable, the Tribal Government should report the value of the benefit to the IRS (and the member) on Form 1099. Even though not supported by formal or informal guidance, IRS auditors are taking the position that if the program is funded by gaming revenue, the Tribal Government should withhold income tax. To illustrate instances in which this has happened, Attachment C provides five examples (drawn from real-life cases) where this approach has resulted in the imposition of withholding taxes on the tribal government.

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<sup>1</sup> City of Alexandria, Virginia, Community Profile p. 21-2 (FY 2011 Approved Budget), which can be found at the following address: <http://alexandriava.gov/uploadedFiles/FY2011ApprovedBudget-CommunityProfile.pdf>.

<sup>2</sup> FY 2011 Approved Budget, p. 17-17 (<http://alexandriava.gov/uploadedFiles/FY2011ApprovedBudget-ParksandRecreation.pdf>)

### **Primary Concerns of Tribal Leaders Regarding the IRS Audits of Tribal Programs**

NCAI has heard from numerous tribal leaders regarding the recent increase in IRS audits of Indian tribal governments, and certain common concerns have been consistently raised. One major concern involves the intrusion on tribal sovereignty that necessarily occurs when tribal governments are asked to provide the kind of detailed background documentation of tribal program and individual tribal members that IRS agents are asking for. A second overriding concern is how these audits, which often appear to be based on questionable legal interpretations, operate to undermine the establishment of a genuine government-to-government relationship between the federal government and federally-recognized tribal governments. Yet another concern is why the federal government should be seeking to tax tribal educational, health and welfare expenditures when, in fact, the tribal government is actually supplementing and supporting the federal government's own failed trust obligations. That concern was echoed by federal legislators in connection with the September 18, 2009 Senate Indian Affairs Committee hearing to explore the Taxation of Health Care Provided by Tribal Governments to Their Members. Tribal leaders are also concerned about attempts to impute income and require 1099 reporting of amount paid to reimburse tribal members for expenses incurred in connection with important cultural activities, such as pow wow celebrations and pueblo feast days.

### **Fair Notice Through Promulgation of Generally Applicable Guidance**

We ask that the Department of the Treasury and IRS promulgate generally applicable guidance on the issues raised above. Specifically, we ask for the following guidance:

- A revenue ruling that re-affirms that the general welfare doctrine may be satisfied if the government program is designed to address a social welfare need, which would include health care, housing, and educational needs, as well as social needs related to tribal language and culture, instead of limiting the doctrine to government programs that require a determination of the recipient's financial need.
- Guidance clarifying that Section 6041 (*i.e.*, Form 1099 reporting) does not apply to tribal government programs merely because they confer an in-kind benefit on tribal members, or reimburse tribal members for tribal expenses.
- Guidance clarifying that Section 3402(r) (*i.e.*, withholding on per capita payments) applies only to actual distributions of gaming revenue and does not apply to government program benefits that are merely funded by gaming revenues.

# ATTACHMENT A

## City of Alexandria Classes, Programs and Benefits

Here is a partial list of classes and programs that the City of Alexandria will provide for its residents this summer.

- Youth or adult swimming classes,
- Youth or adult art classes,
- Youth or adult music classes,
- Youth or adult martial arts classes,
- Youth or adult dance classes,
- Youth or adult sports programs, including gymnastics, fencing, basketball, soccer, lacrosse and football,
- Youth or adult fitness programs,
- Dog training,
- Nature classes,
- Camps, including specific camps for ballet, soccer, baseball, basketball, art, and natural history, tennis, water sports,
- Programs just for teens,
- A free concert series, including concerts at lunch, concerts in the park, and concerts at twilight,
- Community festivals and celebrations, such as a citywide cheerleading competition, a walk-a-thon, a jazz festival, the Alexandria birthday celebration, a film festival, an Irish festival, and a Civil War Camp Day and Skirmish.

However, the benefits of living in Alexandria are not limited to educational, recreational and cultural programs. The City provides the following free home or housing benefits:

- a free Annual Homeownership Fair that allows attendees to learn about a range of issues related to buying a home, including how to qualify for a mortgage, how to overcome past credit issues, how to purchase a house with a small down payment, and the availability of homeownership assistance programs,
- homeownership assistance for households with annual income exceeding \$100,000,
- counseling to educate first-time homebuyers on the purchase process and homeownership issues,
- loans for individuals who do not meet the traditional lending requirements,
- landlord/tenant complaint mediation, and

- relocation counseling for individuals seeking rental housing in Alexandria.<sup>1</sup>

In addition, provides out-of and after-school programs that help children develop self-esteem, cooperation, and critical thinking skills.<sup>2</sup>

Further, Alexandria provides the following health services:

- Teen Pregnancy Prevention and Breastfeeding Programs,
- Child Health Clinic, which provides routine preventive health services for infants and children through age 5,
- Child Dental Clinic, which provides preventative dental care,
- Family Planning,
- HIV/AIDS Services, including testing and counseling for those living with the disease,
- Immunization Clinic,
- Lead in Children, a program that screens for lead levels,
- Nutrition Services, and
- Pregnancy Testing.<sup>3</sup>

Alexandria generally provides the above listed services, class, and programs for free or charges an entry fee that does not cover the total cost of providing such service, class or program. Those receiving Alexandria provided benefits are not taxed on the value of the benefit received.

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<sup>1</sup> Summary of Housing Programs (<http://alexandriava.gov/housing/info/default.aspx?id=361#MIH>).

<sup>2</sup> Recreation Parks & Cultural Activities (<http://alexandriava.gov/recreation/info/default.aspx?id=12382>).

<sup>3</sup> Health Department (<http://alexandriava.gov/health/info/default.aspx?id=11444>).

# ATTACHMENT B

## A Brief History of Code Section 3402(r)

In 1988, Congress enacted the Indian Gaming Regulatory Act ("IGRA") to provide a regulatory scheme for the conduct of gaming on Indian reservations. Section 2710(b)(2) of IGRA (25 U.S.C. §2710(b)(2)) describes the authorized uses of the net revenues from Class II and III gaming activities conducted by Indian tribes: (i) to fund tribal government operations or programs; (ii) to provide for the general welfare of the Indian tribe and its members; (iii) to promote tribal economic development; (iv) to donate to charitable organizations; or (v) to help fund operations of local government agencies.

### **IGRA Context and Notification Requirement**

Pursuant to Section 2710(b)(3) of the IGRA (25 U.S.C. §2710(b)(3)), an Indian tribe may use net revenues from gaming to make per capita payments to members of the Indian tribe, but only if the following requirements are met:

- (A) the Indian tribe has prepared a plan to allocate revenues to authorized governmental or charitable uses;
- (B) the plan is approved by the BIA as adequate, particularly with respect to funding of tribal governmental operations and programs and promotion of tribal economic development;
- (C) the interests of minors and other legally incompetent persons who are entitled to receive any of the per capita payments are protected and preserved; and
- (D) the per capita payments are subject to Federal taxation and ***the tribes notify members of such tax liability when payments are made.***

See 25 U.S.C. § 2710(b)(3) (emphasis added).

The IGRA statute does not define the term "per capita payment." However, in federal regulations promulgated by the Secretary of the Interior, the term per capita payment is defined as follows:

Per capita payment means the distribution of money or other thing of value to all members of the tribe, or to identified groups of members, which is paid directly from the net revenues of any tribal gaming activity. ***This definition does not apply to payments which have been set aside by the tribe for special purposes or programs, such as payments made for social welfare, medical assistance, education, housing, or other similar, specifically identified needs.***

See 25 C.F.R. § 290.2 (emphasis added).

## **Section 3402(r) of the Internal Revenue Code**

In 1994, Congress enacted Internal Revenue Code Section 3402(r) as a tax compliance and revenue raising measure. Section 3402(r) imposes a Federal withholding tax obligation on "any person, including an Indian tribe, making a payment to a member of an Indian tribe from the net revenue of any Class II or III gaming activity conducted or licensed by the tribe." Specifically, the payor must deduct and withhold from such payment a tax equal to such payment's proportionate share of the annualized tax liability.

Although the statutory language of Section 3402(r) does not explicitly limit its reach to per capita distributions of net gaming revenue, the context of the provision's enactment suggests that it was intended to apply only to such payments and not to amounts paid to tribal members through governmental benefit programs. In Stevens v. Commissioner, 452 F.2d 741 (9th Cir. 1971), the court stated that "doubtful expressions are to be resolved in favor of the Indians."

The Senate Finance Committee's described then-current law governing the payment of per capita payments as follows:

Net revenues from certain gaming activities conducted or licensed by an Indian tribe may be used to make taxable distributions to members of the Indian tribe. The tribe must notify its members of the tax liability at the time the payments are made. 25 U.S.C. 2710(b)(3) and (d)(1). The tribe is not required to withhold on such payments except to the extent backup withholding rules apply under Code section 3406.

S. Rep. No. 412, supra. See also H. Rep. No. 826, Part 1, 103<sup>rd</sup> Cong. 2d Sess. (1994), reprinted in 1995-1 C.B. 250. Neither the Internal Revenue Code nor the legislative history of Section 3401(r) define the term "distribution."

Regulations issued under Section 3402(r) also fail to elaborate on the statutory phrase "payment to a member of an Indian tribe from the net revenue of any Class II or III gaming activity." Paragraph (a)(1) of the regulations simply repeats the words of the statute with no explanation, while paragraphs (2)-(4) focus on withholding procedures.

### **Rulings under Section 3402(r)**

Since the enactment of Code Section 3402(r), the Service has considered its application in only a few contexts.

In Technical Advice Memorandum ("TAM") 200035007, a federally recognized tribe provided its members with a variety of educational benefits. Gaming revenues derived from the tribe's casino constituted the primary source of funding for its government and a wide variety of governmental programs. On audit, an Service revenue agent took the position that the amounts paid by the tribe for various education programs should be

considered "distributions of net revenues of Class II or III gaming activities" subject to withholding under Section 3402(r). However, TAM 200035007 concluded that nothing indicated that the Tribe designed the educational programs to distribute net gaming revenue from to tribal members generally. The Service further explained that:

Withholding under Section 3402(r) is not imposed merely by reason of the benefits being sourced in Class II or Class III gaming activities but rather by reason of benefits being taxable income in the form of a payment described in Section 3402(r). Because the described benefits are neither [i.e., neither taxable income nor in the form of a per capita payment or distribution], but are *rather the type of benefits routinely provided by government entities and are being provided in the present case by the Indian tribe in its governmental capacity*, they do not result in income to the recipients or give rise to withholding under section 3402(r).

See Tech. Adv. Mem. 200035007 (September 5, 2000). Thus, TAM 200035007 held that withholding was not required even though the educational benefits provided to tribal members were funded by gaming revenues. See id.

Similarly, Private Letter Ruling ("PLR") 200319850 reasoned that payments triggering discharge of indebtedness under a tribal housing program "do not represent per capita payments or distributions of the net revenues of Class II or III gaming activities within the contemplation of this provision." See Priv. Ltr. Rul. 200319850 (June 6, 2003). Thus, it held that Section 3402(r) did not apply to benefits provided under a tribal housing program.

Furthermore, in Chief Counsel Advice ("CCA") 200138007, the Chief Counsel concluded that if the tribal member housing benefits at issue in the examination were determined to be taxable, they would be subject to Section 6041 reporting. CCA 200138007 did not even consider the potential applicability of Section 3402(r) withholding.

In PLR 200409033, a tribal governmental entity provided educational assistance to tribal members who wished to further their education. Similar to the situation presented in TAM 200035007, nothing indicated that the Tribe provided educational grants in order to distribute net revenues from gaming to tribal members generally. The educational program was funded by a governmental appropriation, not a direct distribution of casino profits. However, under the facts of this ruling, some of that payments were determined to be taxable to the tribal member recipients. Such payments, PLR 200409033 concluded, could trigger a reporting obligation for the Tribe under Section 6041 of the Code. No mention was made, however, of withholding obligation under Section 3402(r).

**We ask that the Department of the Treasury issue guidance clarifying that Code Section 3402(r) withholding does not apply to Indian tribal government program benefits.**

# ATTACHMENT C

## Examples of Issues Raised in IRS Audits of Indian Tribal Governments

In our experience representing Indian tribes in IRS audits, we have encountered various instances in which positions taken by the field agents seemed to lack fairness, consistency or legal foundation. Here are five examples.

- An Indian tribe provided scholarships for tribal children that attended private school (pre-school through grade 12). In an audit, the IRS initially challenged whether the payments for the pre-school tuition were "scholarships" consistent with Code Section 117. The general welfare exclusion was viewed as inapplicable because Tribe distributed per capita payments to each member that were over the median family income for that area.
- Due to decades of abject poverty, an Indian tribe determined that housing conditions on its reservation were still significantly below average. To combat the situation, the Tribal Council authorized a program that provided reimbursement for a specific set of housing expenditures up to a maximum of \$5,000 per member over a two year period. The housing benefit was designed to allow the tribal members maintain or improve their residences. While the tribe's members also began receiving cash per capita payments (which were fully subject to tax), such cash payments were significantly below the median family income in that area. In an audit, the IRS determined that the tribe's housing program benefits were not eligible for exclusion under the general welfare doctrine and should have been treated as additional per capita payments subject to withholding by the Tribe.
- An Indian tribe controls new home construction and occupancy on the reservation. After awarding an tribal family a possessory interest in a yet to be constructed house, the Indian tribe, which remains the owner of the house and underlying property, starts developing the property for construction. The Tribe pays for running sewer lines, water lines, electrical wires, cable, soil testing, and road grading and access. In an audit, the IRS apportions those costs to the tribal family that moved into the house after it was constructed, even though the family's possessory interest can be revoked at any time.
- An Indian tribe provided educational and cultural benefits for its senior members. For example, the Indian tribe sponsored an eight day trip to visit Indian reservations in Montana and South Dakota, the Little Bighorn battlefield, the Custer Battlefield Monument, Devil's Tower, which is a formation sacred to the Indians of the Great Plains, Black Hills National Forest, Black Hills Mining Museum, the graves of Wild Bill Hickok and Calamity Jane, Mount Rushmore, the Crazy Horse Museum, Custer State Park, Wounded Knee Massacre National Historic Site, Sinte Gleska University (the first fully accredited Indian institution for higher education), the Sioux Indian Museum, and Badlands National Park. Another trip was sponsored so that the seniors could attend the grand opening of the National Museum of the American Indian, which included a parade on the National Mall. In an audit, the IRS agent took the position that the value of these two trips were taxable to those elders participating.

- An Indian tribe provides multiple government programs for its members. All government operations, including these programs, are funded through gaming revenues and non-gaming business revenues. In one audit, the IRS took the position that the benefits are taxable and subject to Code Section 3402(r) withholding. After the IRS agrees that Code Section 3402(r) withholding does not apply to programs funded by non-gaming revenues, the IRS requires the Indian tribe to prove that non-gaming revenues were specifically used to fund certain benefits. The Indian tribe provides evidence that the gaming and non-gaming revenues had been co-mingled into one or more government accounts which were then used to fund the various government programs. But it provides evidence of the allocable percentages of funding for each taxable year. account. The Indian tribe requests that the IRS use these percentages when calculating the amount of withholding tax due pursuant to Code Section 3402(r). The IRS refuses this request and applies Code Section 3402(r) to the entire amount of the program expenditures determined to be taxable. However, in another tribal audit with similar facts, the IRS allows an allocation approach to determine withholding tax liabilities.