

BRIEFING PAPER

Date: June 28, 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 government. In preparing this briefing paper, NCAI has consulted extensively with a national law firm that is representing several of the Indian tribal governments 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 re-consideration 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 tribal governments 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 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 Internal Revenue 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 the 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 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) The payment was made by a governmental unit.
- (2) The payment was 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 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, the 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.¹ For fiscal year 2011, Alexandria approved a budget of almost \$19 million for its recreation, parks and cultural activities.² 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. To our knowledge, Alexandria residents receiving the benefits are not taxed on the benefits' value and the City does not issue Forms 1099 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 A 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.

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 detailed background documentation on tribal programs and benefits received by individual tribal members. A second overriding concern is how these audits, which often appear to be based on

¹ 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>.

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

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 Form 1099 reporting of amounts 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 reaffirming 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.