

## **Tribal Finance: Discrimination Against Tribes in the Tax Code and the Capital Markets**

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Upwards of \$50 billion in capital needs go unmet each year in Indian Country in such vital sectors as infrastructure, community facilities, housing, and enterprise development. While the 2001 Native American Lending Study has identified a number of different barriers to tribal access to capital, ongoing research at the University of Michigan is exploring two major barriers that impede tribal access to the capital markets.

### **Discrimination in the Tax Code**

Much of the unmet capital need in Indian Country is due in part to the restrictions imposed on tribal access to the capital markets, specifically the ability of tribal governments to issue tax-exempt debt. Section 7871 of the Internal Revenue Code requires tribal tax-free bond proceeds to only be used for “essential governmental functions,” a restriction not applicable to state and municipal bonds. Section 7871(e) further limits the scope of available tax-exempt bonding authority by stating that “the term ‘essential government function’ shall not include any function which is not customarily performed by State and local governments with general taxing powers” without providing any guidance as to when a particular activity becomes “customary” for a municipal government.

These restrictions have severely limited tribal abilities to access the capital markets, and although American Indians make up more than 1.5% of the population, tribes issued less than 0.1% of the tax-exempt bonds between 2002 and 2004. These restrictions harm the poorer tribes the most, as the differential between tax-exempt and taxable interest rates often determines the feasibility of a project. Without access to tax-exempt rates, poorer tribes simply cannot afford the debt service required to begin to make a dent in the more than \$50 billion in unmet capital needs.

Tribal governments are also victims of a disproportionate number of enforcement actions by the Internal Revenue Service (“IRS”). Only approximately 1% of the more than 15,000 tax-exempt municipal offerings are audited by the IRS each year, but direct tribal tax-exempt bond indentures have a 25% of being audited during their lifetime,<sup>1</sup> and have a 12.5% chance of being audited during their first four years.<sup>2</sup> Additionally, 100% of tribal conduit issuances have been or are currently being challenged by the IRS. The ambiguity of the statute has led to a number of IRS enforcement actions that simply would not have happened had the issuer not been a tribe. In each of

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<sup>1</sup> An earlier estimate of 40% was based on data provided by Thompson Financial. This estimate is being revised downward based on information provided by the IRS. Unfortunately, section 103(c) of the Tax Code defines “state or local bond” for IRS (and IRS enforcement) purposes as an obligation of a State or political subdivision, including bank loans, bond indentures, installment purchases or finance leases. We are currently working with the IRS to determine what percentage of tribal tax-exempt obligations are actually bond indentures. While a survey of the nation’s leading tribal bond lawyers as to the ratio of bank loans to bond indentures provides some insight, at the time these materials were submitted to NCAI, the process of working with the IRS to get a more complete picture and understanding of the numbers is ongoing.

<sup>2</sup> This estimate is similarly based on data provided by the IRS and the survey of tribal bond lawyers, but is also subject to revision as the research project with the IRS proceeds.

these cases, the tribes financed activities that had previously been financed by state and local governments without any challenge from the IRS. In at least one instance, the IRS Chief Counsel's office recommended against the enforcement action because of the weakness of the IRS position.

When the capital markets face uncertainty, their logical response is to charge a price premium. The ambiguity in the statute coupled with the IRS's extreme interpretation of that statute causes such uncertainty, and results in higher interest rates for tribal projects. Additionally, IRS actions have effectively destroyed the market for tax-exempt conduit bonds for tribal projects, even if those projects could have been financed by other conduit borrowers.

Under the status quo, the Tax Code and the IRS are systematically discriminating against tribal governments relative to state and local governments. Congress has the opportunity to rectify this differential treatment simply by rewriting section 7871 to treat tribes as states for all tax purposes, without qualification. Based on the models that I have constructed, the impact on tax revenues of such a change would likely be positive, or at least revenue neutral.

### **Liquidity premium for tribal debt**

Tribal access to the capital markets faces another significant hurdle, as the Securities Act of 1933 exempts municipal debt from SEC registration, but fails to similarly exempt tribal government's municipal debt. Due to the market restrictions for unregistered debt, tribal debt is likely less liquid than comparable municipal debt, and tribal governments are likely forced to pay more in interest than similarly situated state and local governments for the same activities. The existence and magnitude of this liquidity premium has never been empirically verified.

In examining tribal access to the capital markets, a natural methodology for determining a liquidity premium is to obtain the issuance prices of a set of tribal bonds and compare these directly to the issuance prices on "comparable" municipal bond issuers available from a vendor such as the Securities Data Corporation (SDC). Unfortunately, the "natural" methodology is unavailable, as the data on unregistered tribal debt are simply not publicly available in most instances, and the very limited data that are available would not provide a representative sample of tribal issuers.

In order to circumvent data availability problems and issues of selection bias, we are developing a survey of institutional buyers of municipal bonds designed to elicit any liquidity price premium the market imposes on tribal municipal bonds due to their lack of a registration exemption. While the determination of the appropriate offering price of a bond is a function of substantial research and due diligence, particularly in the context of privately placed bonds, the proposed survey will not require respondents to determine a price. Instead the survey participants will be presented with two entities with identical financial attributes, default risks, and levels of disclosure. The two entities will be chosen from a set of three possible entities: a tribal government that is not registered with the SEC ("non-exempt"), a tribal government that is registered ("functionally exempt"), and one municipal government that is automatically exempt from SEC registration requirements. Each of the two chosen entities will be seeking to fund an identical project, and each respondent will be asked if they would require a higher coupon on either of the bonds, holding all relevant market factors identical except for the independent variables (exemption or functional exemption vs. non-exemption, and tribal vs. non-tribal issuer). If the bonds would be priced differently, how much of a premium would be required for the buyer to be indifferent between the two?

At a number of recent tribal finance conferences, Dr. Clarkson has conducted pilot tests of the proposed instrument. Preliminary results strongly indicate that the impediments engendered by differential treatment under the securities law create a market in which institutional buyers of tribal

debt demand an additional 0.75% to 2.5% in interest as a liquidity premium. Pilot testing of this methodology also indicates that such an approach eliminates the need to conduct any sort of initial pricing analysis and instead allows respondents to focus only on any differences in price rather than the prices themselves.

The research will formally test for the existence and magnitude of such a liquidity premium due to registration non-exemptions. In the process, the project will isolate other possible components of higher debt costs for tribes, including what might be referred to as a “racial risk premium” reflecting lenders’ inexperience with and/or mistrust of tribal governments. To ensure an accurate tribal perspective for the survey, based on the suggestions of various tribal leaders, we have developed three scenarios of different sized offerings (a \$10 million land purchase, a \$40 million water treatment plant, and a \$75 million community health clinic), and this factorial design controls for issue size. We separately control for perceptions of default risk by assigning identical credit ratings to each issuer. To control for a new-issuer bias, both the tribe and the town will be presented as repeat issuers with good debt service histories.

### **Effect on Investment Strategies**

Both the liquidity premium and the differential tax code treatment of tribal debt restrict flows of capital into Indian Country, stifle tribal economic expansion, and limit the creation of additional opportunities to fund businesses, particularly for poor tribes. These exogenous factors increase the cost of capital and run the risk of setting the required debt service for any given project at a level beyond the point of economic viability.

If there is a racial risk premium, then it may be more important to educate financial institutions about the mechanics of doing business in Indian Country. The racial risk premium may also apply much more broadly than a liquidity premium on municipal debt.

As long as the barriers of these premiums and biases in the tax code persist, there will remain unmet demand for capital in Indian Country. This research should assist financial institutions in identifying tribal corporations and individual businesses that warrant equity investments but that currently lack capital not because of any fundamental weakness but because of market distortions.