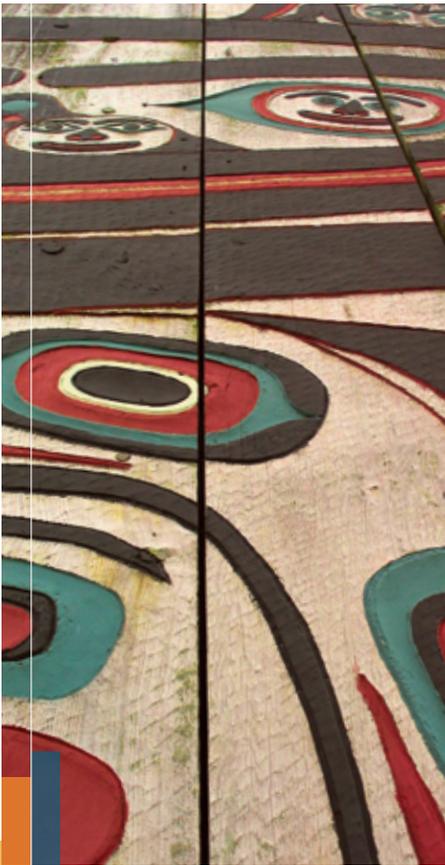




**TAX EXEMPT BONDS & BORROWING  
FOR INDIAN TRIBES**





Many tribal leaders know something about tax exempt bonds and the benefits they offer. These leaders may not have all the answers, but they usually know how and when to ask the right questions. This pamphlet is a compilation of some of the questions we frequently receive together with our brief responses. This Q&A is not meant to be a comprehensive discussion of everything you'd ever want to know about tax exempt borrowing. However, we hope it helps focus the issues and provide some guidance.

#### **WHAT DOES "TAX EXEMPT" MEAN?**

For tribal governments looking to borrow money, the short answer is that "tax exempt" means cheaper costs. Cheaper because the interest payments that you make in repaying the debt are not treated as taxable income to the person who provides the money, and this exemption translates into savings for a tribal borrower. Because the lender or investor does not have to pay taxes on the interest payments they receive, they are willing to offer funding to you at a lower rate of interest. For example, the effective rate of return on a 7.7% taxable loan versus a 5% tax exempt loan is the same. Naturally, a lower rate of interest means lower overall costs to you. Borrowing with tax exempt debt is a tool available only to governments, and it is widely used by states and municipalities to pay for all kinds of public services.

#### **CAN INDIAN TRIBES BORROW USING TAX EXEMPT DEBT?**

Yes, the Indian Tribal Governmental Tax Status Act allows recognized Indian tribal governments and their political subdivisions to borrow on a tax exempt basis. In this context, "recognized" means more than just federal recognition. It involves an acknowledgment process with the IRS, not the BIA. The process is not difficult, and some tribal governments may discover they are already on the approved list. In some cases, the IRS has allowed federally chartered Section 17 corporations to use tax exempt financing. In addition, a tribal government may borrow and transfer the proceeds to a wholly owned and controlled tribal enterprise or agency, which may use the proceeds subject to the various requirements described below.

#### **SHOULD WE ISSUE BONDS, OR SHOULD WE GET A LOAN?**

The benefits of tax exemption are the same whether you borrow through a bond issue or a bank loan. Deciding which method of borrowing is right for you will depend on other factors. Bond issues tend to take longer and have higher transaction costs, but bonds usually offer longer amortization periods—typically, ten years or more—and this extra time for repayment can greatly reduce the bite on current cash flow. Loans, on the other hand, have their own advantages. They tend to be quicker, less complicated and offer an ability to prepay without restriction. It's worth noting,

though, that many banks have no appetite for tax exempt loans larger than \$10 million because the banks lose certain benefits if the loan exceeds that amount, which translates into a higher interest rate on the loan. The \$10 million limitation generally has less effect on bond investors.

#### **ARE THERE RESTRICTIONS ON HOW WE SPEND THE MONEY?**

Yes, there are two basic restrictions on spending. First, Indian tribes may use tax exempt proceeds only to pay for "essential governmental functions." Under the federal tax code, this means functions that are "customarily performed by state or local governments with general taxing powers." Schools, roads and governmental buildings are mentioned as examples, but otherwise the code limits what tribes may do by drawing an analogy to what state or local governments *customarily* do (not what they occasionally do). Furthermore, although the code itself does not say so, the IRS believes that essential governmental functions do not include any commercial or industrial activities—even ones that are customarily undertaken by state and local governments. The IRS has not explained how it distinguishes which revenue-producing activities are "commercial" and which are not, and this narrower interpretation has been a topic of considerable disagreement between tribal governments and the IRS in recent years. In addition to satisfying the essential governmental function standard, Indian tribes also may not loan or use tax exempt proceeds to benefit private parties (i.e., non-governmental users) either through leasing, use, management or other preferential arrangements. These so-called "private activity bond" arrangements are permitted for local governments but not for Indian tribes, except under one very limited circumstance for manufacturing.

#### **MUST THE PROJECT BE LOCATED ON RESERVATION OR ON TRUST LANDS?**

No, in almost all cases, the physical location does not matter. The project may be on or off Indian lands so long as it meets the essential governmental function standard and does not run afoul of the private activity rules. Indeed, road improvements, sewer and water lines, and other basic service infrastructure may cut across many different types of land.



### **ARE THERE RESTRICTIONS ON HOW WE INVEST TAX EXEMPT PROCEEDS?**

Yes. You may not borrow at cheaper tax exempt interest rates solely for purposes of re-investing the money at higher-yielding taxable rates—a practice known as arbitrage. The federal tax rules on arbitrage are highly technical and defy succinct explanation. However, these rules basically do two things. First, they limit the time and circumstances under which you may invest tax exempt proceeds at a yield greater than the yield on the bonds or loan. Second, if you earn arbitrage profits, you must rebate them to the federal government every five years. You may be exempt from these requirements, though, if you spend down the money fast enough according to certain timetables. Generally speaking, the arbitrage rules affect bond issues more than they do loans. This is because loan proceeds are normally advanced to you only as and when they are needed, whereas bond proceeds are advanced to you in full at closing. The draw-down feature of a bank loan limits the amount of proceeds that are available at any given time for investment prior to expenditure.

### **WHAT IF WE'VE ALREADY SPENT MONEY—CAN WE REIMBURSE OURSELVES?**

You may find that you're already incurring costs and spending money on a governmental project before you're ready to borrow. If so, keep in mind that you may recapture those costs and reimburse yourself with proceeds of a tax exempt borrowing if you meet certain requirements. First, the reimbursed costs must be capital expenditures. Second, you must declare your "official intent" to reimburse, which is something normally done by a resolution. This declaration covers all future expenditures as well as expenditures made within the preceding 60 days. Third, you must actually reimburse yourself within permitted timeframes, which can vary. Certain "preliminary expenditures," meaning architectural, engineering, surveying,

soil testing and similar pre-construction expenses, are not subject to these limitations and are fully recoverable in most cases.

### **CAN WE REFINANCE IF INTEREST RATES GO DOWN?**

Within limits, the tax rules will let you refinance to take advantage of interest rate savings. More often, the ability to refinance does not depend on tax rules but rather on the terms of prepayment under the original borrowing. It is standard for fixed rate bond issues to have periods during which the bonds cannot be prepaid, or during which you must pay a premium for redeeming bonds early. This standard does not apply to all bond issues and it is less common for tax exempt loans, which tend to be prepayable at any time without premium.

### **CAN WE COMBINE TAX EXEMPT AND TAXABLE PROJECTS IN A SINGLE BORROWING?**

Yes, tribal governments frequently do so because a single project may contain some components that qualify for tax exempt financing and some that do not. Of course, some savings is better than none. So to address this mix of components, you may simply split the borrowing into two separate series and segregate the borrowed proceeds according to purpose—i.e., a tax exempt project fund for the governmental components and a taxable project fund for the non-governmental components. You may choose to secure both series with the same collateral, and you may borrow for both series using nearly identical documents. You'll find that in a combined borrowing, it is often more efficient to pay off the expensive taxable debt first ahead of the cheaper tax exempt debt. This is generally permitted, subject to certain limitations relating to the useful life of the tax exempt project components.

### **WHAT IF WE CHANGE OUR MIND ABOUT HOW WE'RE GOING TO USE THE MONEY?**

So long as the borrowed proceeds are expended on an essential governmental function that has been properly authorized under tribal law, you may reallocate unspent proceeds from one governmental purpose to another. The same basic requirements discussed elsewhere in these materials would still apply. However, what if all the proceeds were spent, the project was built, and you later want to convert the building to a non-governmental purpose? Under limited circumstances, a change in use will be permitted if your original intentions and subsequent actions were legitimate and if you take certain remedial measures, such as redeem the outstanding bonds. In all cases, changing the use of tax exempt funds from their original purpose is tricky and should not be done without consulting with your bond counsel.



The benefits of tax exempt financing can be enormous. As governments, Indian tribes should make use of every advantage available to them to provide public services to their members at the lowest possible cost. We hope you find this pamphlet informative. For additional information, please see *Ten Questions Tribal Council Should Ask Before Borrowing Money* and other publications by Orrick's Indian Tribal Finance Group.



## ABOUT ORRICK

Orrick has been the nation's top-ranked bond counsel firm for more than a decade and is listed in Band 1 (highest category) in the field of Native American Law by *Chambers USA—America's Leading Lawyers for Business*.

We have been privileged to represent tribal governments in more than a dozen states on a variety of projects, including land acquisitions, health clinics, tribal housing, schools, government administration buildings, cultural centers, tribal utilities, parks and recreation facilities, and so on. In addition, we have represented tribal business enterprises in gaming, hotel and entertainment facilities, manufacturing plants and other commercial activities. Our Indian Tribal Finance Group is nationwide and comprises lawyers from our Public Finance, Corporate, Banking, Tax and Securities practices.

For more information or assistance, please contact Townsend Hyatt, Chair of Orrick's Tribal Finance Practice, at (503) 943-4820 or [thyatt@orrick.com](mailto:thyatt@orrick.com).

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