



Client Alert

New Tax-Exempt and Tax-Credit Bonds Available to Tribes to Finance Hotels and Other Amenities

Indian tribes have a significant new opportunity to finance commercial developments using tax-exempt bonds and tax-credit bonds, thanks to the recently enacted American Recovery and Reinvestment Act of 2009. Tribes are now able in the aggregate to issue up to US\$2 billion of these bonds to finance commercial developments, including hotels, convention centers and other amenities, but not casinos, on their reservations.

Tribal Economic Development Bonds

The Act enables tribes to issue Tribal Economic Development Bonds to finance any commercial activity that may be financed on a tax-exempt basis by a state or local government, including hotels, convention centers and other amenities, subject to the following restrictions:

- the bonds may not be used to finance any portion of a building in which class II or class III gaming is conducted or housed or any other property actually used in the conduct of such gaming¹
- the project must be located on an Indian reservation
- the bonds must be issued pursuant to an allocation of a portion of the US\$2 billion volume limitation available for all tribes
- the bonds may not be “private activity bonds,”² other than certain “qualified bonds”³

As a result of the prohibition on the bonds being used to finance a casino or property actually used in the conduct of gaming, the project being financed must be structurally independent of the casino. This requirement does not prevent the non-casino portions of the project from being connected to the casino by a covered walkway or other means, so long as the buildings are separate structures. While each project will need to be separately evaluated, we believe that these new rules provide significant opportunities for tribes to use tax-exempt financings to finance the non-casino portions of a project.⁴

Build America Bonds

The Act also provides for the issuance of Build America Bonds as an alternative for any project that is eligible to be funded with Tribal Economic Development Bonds (other than private activity bonds).⁵

With Build America Bonds, the tribe can elect either to provide bondholders with a tax-credit equal to 35 percent of the interest paid on the bonds or to receive a payment from the United States Treasury (the “Treasury”) equal to 35 percent of the interest paid on the bonds.

Build America Bonds must meet the requirements of Tribal Economic Development Bonds and the following additional restrictions:

- the bonds must be issued in 2009 or 2010
- where the tribe receives the federal subsidy of 35 percent of the interest payments from the Treasury, the proceeds of the bonds must be used only for capital expenditures and a reasonably required reserve fund (which generally is up to ten percent of the proceeds of the bonds held for debt service in case the issuer encounters financial difficulty) and may not be used to repay other debt

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Should you have any comments or questions, please contact, at your convenience:

James F. Hayden
Partner
+ 1 212 819 8722
jhayden@whitecase.com

Gary Kashar
Partner
+ 1 212 819 8223
gkashar@whitecase.com

Kenneth Suh
Partner
+ 1 212 819 8995
ksuh@whitecase.com

Jin Kim
Partner
+ 1 212 819 8994
jinkim@whitecase.com

White & Case
1155 Avenue of the Americas
New York, NY 10036
+ 1 212 819 8200

www.whitecase.com

- the bonds may not be issued with more than an insignificant premium (i.e., no more than 25 basis points multiplied by the number of complete years until maturity of the bonds)

One important advantage of the Build America Bonds where the tribe elects to receive the federal subsidy of 35 percent of the interest payments is that there is no restriction on the use of those funds. They can be pledged as collateral for the bonds or can be used for any other purpose.

The IRS recently released guidance setting forth the procedures for the payment of the interest subsidy to issuers of Build America Bonds.⁶ Issuers can claim the credit by filing IRS Form 8038-CP, "Return for Credit Payments to Issuers of Qualified Bonds." The IRS will begin to accept such forms on May 1, 2009 and will be prepared to make timely payments with respect to interest payment dates beginning on or after July 1, 2009.⁷ Payments can be made to the issuer or to another person designated by the issuer, though the IRS has asked for comments as to whether such payment should be made solely to the issuers.⁸

For fixed rate bonds, the interest credit payment can be made on the interest payment date if the issuer files Form 6038-CP at least 45 days prior to, but no earlier than 90 days before, such interest payment date. For floating rate bonds, interest credit payments are paid quarterly to reimburse interest payments made in the quarter, with the Form 6038-CP due 45 days after the last interest payment date for the quarter for which reimbursement is requested.⁹

It is also worth noting that in the case of Build America Bonds where the tribe elects to receive the federal subsidy for 35 percent of the interest payments, the risk of the bonds qualifying as tax exempt in order to qualify as Build America Bonds would fall on the tribe and not the holders, so that such bonds should be able to be marketed as typical taxable bonds.

Private Activity Restriction

In order to qualify for financing with Tribal Economic Development Bonds or Build America Bonds, the project cannot be used in a private business of a person other than the tribe. The private use rules are complex and require an analysis of each particular project. The private use concern arises in financings of hotels,

convention centers and other amenities if the tribe enters into a management contract with a nontribal entity to manage all or a portion of the financed project, such as a hotel management agreement. Management contracts with fees based on the net profits of the facility are generally prohibited. However, the IRS has permitted hotel management contracts for facilities financed by state and local issuers that call for a larger periodic fixed fee and a smaller fee based on gross revenues or expenses, with a one-time bonus based on a gross revenue or expense target.

Some examples of hotel management contract terms that the IRS has found permissible contain the following fee structures: (1) a periodic fixed fee that constitutes 95 percent of the total fees where the management contract has a term of 80 percent of the facility's expected useful life or 15 years, whichever is shorter, (2) a periodic fixed fee that constitutes 80 percent of the total fees where the management contract has a term of 80 percent of the facility's expected useful life or ten years, whichever is shorter, and (3) a periodic fixed fee that constitutes 50 percent of the total fees and the management contract has a five-year term that is terminable without penalty after three years.¹⁰

Other fee structures may also be permissible, but will need to be considered on a case-by-case basis. In addition, leasing all or a portion of the project to a nontribal entity, such as leasing stores in a shopping mall, could cause a loss of the tax-advantaged status of such bonds if in excess of ten percent of the financed facility is subject to such leases over the term of the bonds or the expected useful life of the project. Measuring the amount of private use of a facility is generally done annually on the basis of, for example, square footage in the case of real property, output in the case of generating facilities, days of use for arenas or other measures of capacity for their facilities. A management contract for a facility would be considered use of the entire facility or such lesser portion as is subject to the contract. To compute the ten percent limitation on private use, private use is compared to total use of the facility.¹¹

In addition, the project cannot be used in a manner that provides "special legal entitlements" to any person other than the tribe, such as a right of preferential use or the ability to set rates. If an amount in excess of ten percent of the financed facility is subject to "special legal entitlements," the bonds could be "private

activity bonds,” which will cause them to lose their status as tax-exempt or tax-credit bonds. For example, the limitation on granting “special legal entitlements” could arise if: (1) the casino is managed pursuant to a management contract that is treated under IRS guidelines as giving rise to private use and (2) there are arrangements between the casino and the hotel or other aspects of the project that gave the casino “special legal entitlements,” such as granting of comps in excess of the ten percent limitation. The “special legal entitlements” restrictions would not be implicated if the casino is run by the tribal government, since in that case it is the tribe that is receiving the entitlement. Generally, tribal governments and wholly owned instrumentalities of tribal governments, such as gaming authorities, are treated as the same for this purpose.

Which to Choose?

Several factors can influence which of these bonds a tribe should issue. Interest rates and bond terms demanded by tax-exempt and taxable bond investors can vary depending on conditions in their respective markets. In addition, if Build America Bonds are being issued, the tribe’s decision whether to elect to receive the 35 percent federal subsidy or to allocate the tax-credit to the bondholders may depend on the tax situation of the potential investors. For example, if the bonds are marketed to investors that have experienced capital losses, and are therefore not able to take advantage of the tax-credit, it may be more advantageous for the tribe to elect to receive the 35 percent federal subsidy. Tribes should work closely with their financial advisors when deciding which of these bonds is most advantageous.

Many of the procedures that must be followed in issuing Tribal Economic Development Bonds and Build America Bonds were not specified in the Act and will require further guidance. Recently, an official of the US Department of the Treasury (the “Treasury Department”) stated that some initial guidance with respect to these procedures should be released by the IRS or the Treasury Department within 30 days.¹²

Allocation of US\$2 Billion Cap

The US\$2 billion of Tribal Economic Development Bonds and Build America Bonds is to be allocated by the Treasury Department among all Indian tribes in such a manner as the Treasury Department, in consultation with the Department

of the Interior, determines is appropriate.¹³ Neither the method of allocation nor the process for obtaining an allocation has been determined. Factors that may be considered include reservation population, tribal membership, project feasibility and project benefits, but the Act does not specify any particular criteria.

Planning Ahead

There are restrictions on the tax-exempt financing of projects after spending on such projects has begun. Reimbursement of project costs incurred is generally allowed only if the bond issuer adopts a notice of official intent to reimburse those costs from the proceeds of tax-exempt bonds. Certain preliminary expenditures, such as architectural, engineering, surveying, soil testing and similar costs incurred prior to the commencement of construction, can be reimbursed with tax-exempt bond proceeds without a notice of intent to reimburse, but only in an amount up to 20 percent of the principal amount of tax-exempt bonds issued.¹⁴

If such a notice is adopted, the proceeds of the Tribal Economic Development Bonds or the Build America Bonds can be used to reimburse the tribe for expenditures made up to 60 days prior to the date of adoption. Therefore, we recommend that tribes adopt a notice of official intent to reimburse the project costs as early in the project as possible. The notice can be in any reasonable form, such as a resolution of the tribe, and should generally describe the project involved, state the maximum principal amount of obligations expected to be issued for the project and identify the source of funds for the project expenditures. To take advantage of the reimbursement, the allocation of the bond proceeds to such expenditures must be made not more than 18 months after the later of the date the expenditure is made or the date the project is placed in service or abandoned, but in no event more than three years after the original expenditure is paid. In the case of Build America Bonds where the 35 percent interest subsidiary is to be paid to the issuer, such cost reimbursement is allowed only for costs paid or incurred after the effective date of the Act, February 17, 2009.¹⁵

Refinancing

A tribe may issue Tribal Economic Development Bonds (other than Build America Bonds as to which the issuer elects to receive the 35 percent interest subsidy from the Treasury Department) to

refinance debt incurred by such tribe, its tribal corporations and tribal authorities, and other entities sufficiently related to the tribe if: (1) the refinanced debt is tax exempt, or (2) such refinanced debt is taxable, the proceeds were used for project costs of the type now financeable by Tribal Economic Development Bonds or Build America Bonds, and the payment of such project costs is sufficiently traceable to such refinanced debt.

Conclusion

The Act greatly broadens what Indian tribes can use tax-exempt and tax-credit bonds to finance and could lead to a significant increase in commercial development on Indian reservations. Prior to the Act's passage tribes could offer tax-exempt bonds only to finance "essential government functions," a term the US Internal Revenue Service interpreted very narrowly, and certain manufacturing activities. Tribes were thereby prevented from offering tax-exempt bonds to fund commercial and industrial development. Now, with the exception of casinos, tribes will be able to offer tax-exempt bonds and tax-credit to finance hotels, convention centers, and other related developments.

To maximize the advantages of this new financing opportunity, tribes will need to consult with their financial advisors when choosing which of these bonds they issue. This choice will vary from market to market. Careful planning before spending on a project begins will also be needed, since there are significant restrictions on the tax-exempt financing of projects once spending has begun. Many procedures have not been finalized, including the method of allocating the US\$2 billion of bonds among tribes. Tribes will need to stay alert to the finalization of these procedures and allocation methods to ensure they obtain an appropriate allocation and comply with all financing requirements.

- (II) in which the holder of the card covers such numbers or designations when objects, similarly numbered or designated, are drawn or electronically determined, and
- (III) in which the game is won by the first person covering a previously designated arrangement of numbers or designations on such cards, including (if played in the same location) pull-tabs, lotto, punch boards, tip jars, instant bingo, and other games similar to bingo, and
- (ii) card games that
 - (I) are explicitly authorized by the laws of the State, or
 - (II) are not explicitly prohibited by the laws of the State and are played at any location in the State, but only if such card games are played in conformity with those laws and regulations (if any) of the State regarding hours or periods of operation of such card games or limitations on wagers or pot sizes in such card games.

"class II gaming" does not include

- (i) any banking card games, including baccarat, chemin de fer, or blackjack (21), or
- (ii) electronic or electromechanical facsimiles of any game of chance or slot machines of any kind.

"class III gaming" means all forms of gaming that are not class I gaming or class II gaming.

- 2 § 1402 of the Act and Internal Revenue Code § 7871(f).
- 3 § 141 of the Internal Revenue Code describes "qualified bonds," which include exempt facility bonds, such as those issued for airports, dock and wharves, solid waste disposal facilities and sewage facilities, as well as certain mortgage bonds, student loan bonds, small issue manufacturing bonds and bonds issued for nonprofit institutions.
- 4 The National Association of Bond Lawyers ("NABL") has asked the IRS to confirm whether Tribal Economic Development Bonds could be issued to finance the noncasino portion of a building in which gaming takes place. Letter dated March 2, 2009 from William A. Holby, President of NABL, to John J. Cross, III, Associate Tax Legislative Counsel, US Department of Treasury and James A. Polfer, Branch Chief, IRS, transmitting "Recommendations for Guidance under ARRTA" dated February 27, 2009.
- 5 § 1531 of the Act.
- 6 IRS Notice 2009-26 [April 3, 2009].
- 7 Section 3.1(a), IRS Notice 2009-26.
- 8 Section 6, IRS Notice 2009-26.
- 9 Section 3.1, IRS Notice 2009-26.
- 10 The Internal Revenue Service has described allowable types of management contracts in Rev. Proc. 97-13, 1997-1 CB 632, as modified by Rev. Proc. 2001-39, 2001-2 CB 38.
- 11 § 1.141 of the Treasury Regulations sets forth the rules for measuring private business use.
- 12 Statement of John J. Cross, III, Associate Tax Legislative Counsel, US Department of Treasury, to NABL conference on March 5, 2009. 2009 TNT 42-1.
- 13 § 1402 of the Act and Internal Revenue Code § 7871(f)(1)(A)
- 14 In addition, a de minimis amount of bond proceeds equal to the lesser of US\$100,000 and five percent of the proceeds of the issue can be used for reimbursement without application of the rules relating to the adoption of an official notice of intent to reimburse.
- 15 Section 2.3, IRS Notice 2009-26.

1 The Indian Gaming Regulatory Act, 25 U.S.C. 2701 et seq., generally defines class I, class II and class III gaming as follows: "class I gaming" means social games solely for prizes of minimal value or traditional forms of Indian gaming engaged in by individuals as a part of, or in connection with, tribal ceremonies or celebrations.

"class II gaming" means:

- (i) the game of chance commonly known as bingo (whether or not electronic, computer, or other technologic aids are used in connection therewith)
- (II) which is played for prizes, including monetary prizes, with cards bearing numbers or other designations,

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