

Tips and Strategies for Defending Indian Tribal Government IRS Audits



By Rob Roy Smith

Indian tribes are no strangers to the Internal Revenue Service ("IRS"). Tribes are thirty times more likely than states or municipalities to be audited concerning tax-exempt bond issuance. Now, however,

Indian tribes are being targeted for a more invasive form of IRS audit. The Indian Tribal Governments ("ITG") division continues to shift its mission from education to enforcement, resulting in a dramatic increase in examinations of Indian tribal governments for compliance with myriad federal tax laws.

The stakes are high. An audit can be disruptive, time consuming, and very expensive—in some cases exceeding \$2 million, excluding defense costs. This article provides an overview of the examination process, summarizes strategies for Indian tribes facing an audit, and offers four tips to limit tax liability.

What Is the ITG?

The ITG was established seven years ago to assist federally recognized Indian tribes with federal tax matters.¹ The ITG is divided into five field groups; federal tax matters involving Indian tribes in Washington state are handled through the ITG office in Portland, Oregon.²

Initially, the ITG was to "use partnership opportunities with Indian tribal governments ... to respectfully and cooperatively meet the needs of both the Indian tribal governments and the federal government and to simplify the tax administration process."³ Through this process, the IRS gained unprecedented access to accounting information. In 2004, the ITG's focus shifted towards enforcement and it began using the information gathered during education efforts to assess taxes and penalties.

Scope of Examinations

Successful tribal economic development has increased tribal payrolls and payments made by tribes to vendors for services. These payments trigger certain tax reporting and withholding requirements.⁴ ITG examinations have primarily focused on information return reporting, employment tax withholding, and tip income reporting.

Information return examinations focus on the taxability of payments to tribal members and vendors. Tribes must file information returns for certain payments made in the course of trade or business aggregating \$600 or more in a calendar year.⁵ The IRS pays particular attention to whether tribes have obtained a taxpayer identification number (e.g., Social Security number) prior to making a payment.⁶

Employment tax examinations focus on employee vs. independent contractor issues. Every employer paying wages to an "employee" must deduct and withhold certain employment taxes.⁷ Independent contractors are not subject to such withholding. If a tribe has the right to control what must be done and how it must be done, the worker is an employee, and federal withholding requirements apply.⁸

Tip tax examinations look for underreporting of tips by employees of tribal gaming enterprises and restaurants.⁹ Tribes can be liable for FICA tax if tips are not properly reported.

The *ITG Work Plan* indicates that ITG's focus for 2008 will be expanded to include anti-money laundering exams.¹⁰ ITG plans to conduct Bank Secrecy Act compliance checks to validate that tribal entities are meeting training, oversight, and record-keeping requirements.¹¹

What Is at Stake?

There is limited information available on ITG examinations. Twenty-five percent of examinations between FY 2002 and 2005 resulted in a change in tax liability.¹² Eighty-one percent of all examinations were directed at gaming-related tribal entities. The average assessment in unpaid tax for gaming-related entities was \$209,000. Tax adjustments

for the period totaled \$1.4 million. Additional penalties and interest assessed totaled \$1.7 million.

Clearly, Indian tribes risk significant liability for failure to strictly adhere to federal tax laws. Failure to properly process information returns can cost tribes up to \$100 per return.¹³ If a tribe fails to obtain a taxpayer identification number before issuing payment, the IRS will assess "backup withholding" requiring a payment to the IRS of 28% of such payments.¹⁴

Unpaid Social Security and Medicare taxes, and penalties are assessed on the amount of income found to be incorrectly paid to persons through information returns rather than reported as wages.¹⁵ Tax and penalty assessments can easily reach six figures.

(continued on page 13)

Tips and Strategies for Defending Indian Tribal Government IRS Audits from page 5

A Bank Secrecy Act examination at a tribal casino can be expensive.¹⁶ In 2006, the Tonkawa Tribe of Oklahoma consented to the assessment of \$2.5 million in civil penalties for Tribal Casino violations under the Bank Secrecy Act.¹⁷ The scope of these civil and criminal penalties makes the prospect of increased ITG focus on the Bank Secrecy Act particularly worrisome.

We're Being Audited! What Do We Do?!?

IRS examinations begin innocuously with the issuance of an Information Document Request ("IDR").¹⁸ Upon receipt, a tribe should designate a qualified attorney or accountant to serve as the Power of Attorney for the examination.¹⁹ This will free the Tribal Council from day-to-day audit management.

Provide nothing more than the documents requested in the IDR as they are kept in the normal course of business.²⁰ Do not withhold documents.²¹ Because the applicable statute of limitations is three years,²² an IDR received in 2008 might request records dating to fiscal year 2005.

The IDR will establish a time and place for a "field examination" to review the records. Multiple IDRs and field audits are possible. Agents are encouraged to set initial appointments within fourteen days of IDR issuance.²³ Tribes should reschedule field examinations to allow sufficient time to locate records and conduct confidentiality reviews. Examinations should take place somewhere other than the tribe's place of business to avoid inadvertent releases of information that might occur when the IRS observes day-to-day operations of the tribal business.

During the examination, tribal positions should be thoroughly documented. Tribes should insist that the ITG examiner asks her questions in writing. This creates an appeal record if necessary.

If an error is discovered, the ITG examiner will propose a change in the entity's tax liability. A tribe will have thirty days to respond by requesting a conference with the ITG manager or by appealing to the IRS Appeals Office or the United States Tax Court.²⁴ The question will be whether

(continued on next page)

Tips and Strategies for Defending Indian Tribal Government IRS Audits from page 5

it is best to reach a compromise agreement or fight the assessment. Be realistic. Reaching an informal agreement with the ITG manager is often cheaper and faster.

Four Tips to Limit Tax Liability in the Future

What is a tribe to do? If no audit has occurred, tribes should conduct a "self-audit" to discover and fix any compliance problems. For audited tribes, additional ITG compliance reviews will likely take place to determine whether changes have been made to tribal accounting practices to ensure compliance with tax laws. If insufficient progress is made, another costly audit might follow. Following these four tips can help limit prospective tax liability.

First, improve document management. Tribes should keep detailed accounts payable and check register information, including all supporting check request documents, for at least six years.

Second, improve internal controls. Tribes should make sure that a Form W-9 is received from every vendor before a payment is issued. Acquiring a payee's correct taxpayer identification number takes little time and can save thousands of dollars in penalties. Accounting staff should receive periodic tax training to ensure that tax is correctly withheld from wages.

Third, develop tax-aware policies. Certain "general welfare" payments and scholarships and tuition aid for students are neither taxable nor reportable if properly paid.²⁵ Too often, tribes fail to appropriately document the process for making these payments, triggering otherwise avoidable tax liability for the tribe and the recipient tribal member.

Fourth, take advantage of IRS offers. For instance, the IRS offers protection from tip tax examinations for employers who enter into Tip Rate Determination Agreements. While these agreements might seem more burdensome than the status quo, they can result in tax savings over time.

Conclusion

An IRS audit might be unavoidable; however, paying substantial taxes and penalties to the IRS can be avoided. Do not wait to be audited. Indian tribes can structure business practices to limit the substantial penalties that accompany an examination. The investment of time and resources to review tribal businesses practices through a "self-audit" before the IRS comes to your door can result in substantial savings in the long term and more transparent policies governing payments to vendors, employees, and tribal members.

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resource protection, taxation, tribal sovereignty, and gaming. Rob has substantial experience directing response to and defense of IRS audits of tribal governments and tribal enterprises. As required by the IRS, nothing in this article should be construed as tax advice and should not be used to avoid Federal tax penalties. The author encourages Indian tribes facing an audit to consult with legal and tax professionals.

- 1 See Internal Rev. Manual § 22.41.1.2.2.B available at <http://www.irs.gov/irm/part22/ch07s01.html>. "While the Indian Tribal Governments office has enforcement authority, it is our objective to work with tribes to mitigate the need for enforcement." *Id.* available at <http://www.irs.gov/irm/part4/ch56s01.html> (emphasis added); see also 26 U.S.C. § 7602(a).
- 2 <http://www.irs.gov/govt/tribes/article/0,,id=96133,00.html> (last visited Jan. 28, 2008).
- 3 <http://www.irs.gov/govt/tribes/article/0,,id=96135,00.html> (last visited Jan. 28, 2008).
- 4 Rev. Rul. 67-284, 1967-2 C.B. 55.
- 5 26 U.S.C. §§ 6041(a), 6041(d). This filing requirement applies to payments of salaries, wages, and other forms of compensation for services. Certain payments do not constitute income and, therefore, generally do not require 1099 reporting, including: the purchase of goods; payments made to corporations, except for medical and health care payments in excess of \$600; wages and travel reimbursements/allowances paid to employees; payment of a "scholarship," "fellowship grant," or "qualified tuition" payments; and, foster care payments. See Form 1099-MISC Instructions; IRS Reg. § 1.6041-3(p)(1); IRS Reg. § 1.117-3(a); IRS Pub. 4268 at 58 (May 2005).
- 6 See generally 26 U.S.C. § 3406.
- 7 26 U.S.C. § 3402(a).
- 8 Rev. Rul. 87-41.
- 9 26 U.S.C. §§ 3111(a), 3111(d), 3121(a).
- 10 http://www.irs.gov/pub/irs-tege/fy_2008_itg_work_plan.pdf (last visited Jan. 28, 2008).
- 11 *Id.*
- 12 <http://www.treas.gov/tigta/auditreports/2006reports/200610121fr.html> (last visited Jan. 31, 2008).
- 13 26 U.S.C. § 6721.
- 14 26 U.S.C. § 3406(a).
- 15 26 U.S.C. §§ 3101, 3111, 3402, 3509(a).
- 16 31 C.F.R. §§ 103.32-103.38; 103.49(a)-(d); 103.57(c)-(d); 103.57(f); 103.57(h).
- 17 http://www.fincen.gov/tonkawa_pr.html (last visited Jan. 28, 2008).
- 18 26 U.S.C. § 7602(a)(1) (authorizing revenue agents to inspect records).
- 19 26 U.S.C. § 6103(c).
- 20 See, e.g., *United States v. Mobil Corporation*, 499 F.Supp 479 (N.D. Texas 1980) (holding that taxpayer was not required to produce records in a format that it did not keep in the ordinary course of business).
- 21 If a taxpayer fails to produce the required information, the IRS can issue an administrative summons. 26 U.S.C. § 7602(a)(2). However, certain documents may be withheld. For instance, confidentiality protection for certain communication between a taxpayer and an attorney has been expanded to apply to similar communications between a taxpayer and any federally authorized practitioner, e.g., a CPA. 26 U.S.C. § 7525.
- 22 26 U.S.C. § 6501(a).
- 23 Internal Rev. Manual § 4.10.2.7.4. (continued on next page)

Tips and Strategies for Defending Indian Tribal Government IRS Audits
from page 5

24 See IRS Pub. 3498.

25 The general welfare exclusion applies only to governmental payments from a welfare fund based upon the recipients' identified need (which need not necessarily be financial), and not where made as compensation for services. See, e.g., Rev. Rul. 2003-12, 2003-2 C.B. 1007. An IRS memorandum lists the requirements of a general welfare plan as follows: (1) the payment is made from a government general welfare fund; (2) the payment is made on the basis of need; and (3) the payment is not for services. IRS Mem. 200021036 at 3 (2000). Payments from federally recognized tribes meet the requirement that the payments be made by a "government." See, e.g., IRS PLR 200632005 (Aug. 11, 2006); Rev. Rul. 74-205, 1974-1 C.B. 20; Rev. Rul. 68-38, 1968-1 C.B. 446.