

1-1-1981

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Quentin Michael Jones

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### Recommended Citation

Quentin M. Jones, *Mineral Resources: Tribal Development of Reservation Oil and Gas Resources Through the Use of a Nontaxation-Based Tribal Joint Development Program*, 9 AM. INDIAN L. REV. 161 (1981),  
<https://digitalcommons.law.ou.edu/ailr/vol9/iss1/7>

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# MINERAL RESOURCES: TRIBAL DEVELOPMENT OF RESERVATION OIL AND GAS RESOURCES THROUGH THE USE OF A NONTAXATION-BASED TRIBAL JOINT DEVELOPMENT PROGRAM

Quentin Michael Jones\*

## Introduction

Traditionally, natural resources occurring on tribal lands within a reservation, including oil and gas resources, have been developed through a process of leasing. Under this process the federal government would lease tribal oil and gas to non-Indian developers in the oil and gas industry, pursuant to the regulations set forth in 25 C.F.R. § 171 (1979),<sup>1</sup> under the terms of Form 5-157 (July, 1964).<sup>2</sup> Tribal involvement in this process was, also by tradition, passive if not submissive.

The minimal involvement of tribes in the development of their reservation resources stems from the federal government's purpose and rationale in selecting the leasing process to carry out its trust responsibility, i.e., to "make such changes in the management and disposition [of tribal property] as it deems necessary to promote their [tribal] welfare."<sup>3</sup> Leasing was originally applied to maintain or increase the "value" of tribal lands, which was considered diminished because of the inalienable status of trust or restricted lands.<sup>4</sup> It was also recognized that "mining depletes the

\*First-place winner, 1981 Indian Law Writing Competition. Third year law student, University of New Mexico.

1. See also Proposed Reg., 25 C.F.R. § 182, 45 Fed. Reg. 57,173 (Aug. 11, 1980), which emphasizes "contracting" over leasing of oil and gas resources.

2. Titled *Oil and Gas Mining Lease for Tribal Indian Lands*. The terms of the lease provide for, among other things, a 12½% royalty on production, except for that used by the lessee, which has been increased in some recent leases to 16⅔%. It also provides for valuation of oil and gas based upon either the highest price paid or offered at the time of production, or calculated from the actual volume of marketable product less foreign substances; a 10-year primary term; and, "reasonable diligence" in development and operation, or in lieu of drilling, the payment of an amount not to exceed \$1 per acre. See also 25 C.F.R. § 171.19 (1979).

3. *Morrison v. Work*, 266 U.S. 481, 485 (1925).

4. Maintaining value by putting tribal mineral land to use is reflected by the following: "It has been customary for the Secretary under his general authority over Indian Affairs to make revocable permits on tribal lands which could not be leased under the statutes in order to preserve the value of the lands and to obtain a revenue from them rather than allowing them to lie idle." 1 Op. Sol. Dep't Interior 714, 715 (1937).

property rather than preserving its value.”<sup>5</sup> Nevertheless, the leasing of tribal mineral resources to nontribal developers was seized upon by the federal government not only for tribal benefit but also for the benefit of the government, the states, and the oil and gas industry.<sup>6</sup>

For tribes, the principal benefit of the leasing process has been the royalty and rental income received.<sup>7</sup> These forms of income are free of production costs<sup>8</sup> and are free of state<sup>9</sup> and federal<sup>10</sup> taxation. Some tribes also have been able to expand and increase their benefits under the Form 5-157 lease by the incorporation of stipulations to the lease.<sup>11</sup> In addition, the ease with which a tribe may enter into a lease and the minimal obligations a tribe must accept have attracted tribes wishing to develop tribal oil and gas to the passive role of lessor, especially where the tribe is in the initial stages of development, or where the tribe does not possess the requisite technology or financial resources for development.

The problems tribes typically encounter under the leasing process generally arise from the limitations inherent in development through leasing. Once the lease is executed the terms of development are sealed; the tribe (and the mineral lessee) must live with

5. *Id.*

6. For instance, the legislative history of a leasing act lists some other purposes of leasing: “1. Permit the exploration for oil and gas on Executive Order Indian reservations. 2. Give the Indian tribes all the oil and gas royalties. 3. Authorize the States to tax production of oil and gas on such reservations. 4. Place with Congress the future determination of any changes of boundaries . . . 5. Extend relief to permittees and applicants who in good faith expended money in development looking to the discovery of oil and gas. . . .” (S.Rept. No. 1240, at p.3; H.R. Rep. 1791, at p.3)” 2 Op. Sol. Dep’t Interior 1921, 1922 (1963).

7. Such income includes income from bonus, and advance and minimum royalty provided for in the terms of the Form 5-157 lease, or stipulations to the lease.

8. Although such royalty may not be free of subsequent-to-production costs, e.g., costs of treatment of the product to make it marketable, or costs of transportation to market. *See generally* H. WILLIAMS & C. MEYERS, OIL AND GAS LAW—MANUAL OF TERMS, “Royalty,” 511 (1976).

9. *See* Tax Status of the Production of Oil and Gas From Jicarilla Apache Tribal Lands Under the 1938 Indian Mineral Leasing Act, 86 I.D. 181 (1979), which amplifies Tax Status of the Production of Oil and Gas From Fort Peck Tribal Lands Under the 1938 Indian Mineral Leasing Act, 84 I.D. 905 (1977).

10. *See* Rev. Rul. 67-284, 1967-2 C.B. 55, 57.

11. Among the stipulated terms commonly incorporated into a lease are the following: (1) a five-year primary term; (2) royalty increased to 20 percent, plus a higher advanced rental amount; (3) inclusion of an “unless” clause; (4) a minimum royalty clause; (5) a water well conversion clause; (6) a grazing rights protection clause; (7) a preservation of antiquities clause; and (8) a clause requiring tribal approval of the drilling site location.

the lease even though its royalty and rental provisions have waned in the presence of potential profit from decontrolled domestic oil or gas prices.<sup>12</sup> This means that the tribe must live with its perception of "greener pastures." However, notwithstanding the problem of inflexible terms under a lease, the real problem such a tribe must overcome is that of lease enforcement. Such enforcement does not lie within the province of the tribe but exists as a function of the Secretary of the Interior, through implementation by the United States Geological Survey. Unfortunately, this enforcement and the protection of tribal interests can be a heavy burden for the secretary and a disappointment for a tribe.

In *Jicarilla Apache Tribe v. Supron Energy Corp.*,<sup>13</sup> the court examined secretarial enforcement of and lessee compliance with the terms of lease Form 5-157.<sup>14</sup> In holding the secretary in breach of trust responsibility for failure to monitor the lessee's duty to diligently develop, failure to protect against drainage, and failure to require proper accounting from the lessee,<sup>15</sup> the court shifted the emphasis of responsibility for performance under the lease from compliance by the lessee to enforcement by the secretary. In such a case the relief sought by a tribe for breach of lease terms does not depend so much on whether there was compliance by the lessee but on whether there was enforcement by the secretary. Thus, any remedy available to a tribe for a lessee's breach of lease terms, for example, cancellation of leases, could be undermined by a finding of breach of trust responsibility by the secretary. The possible effect of such a determination is relief without substance—requiring the secretary to enforce leases that cannot be enforced.<sup>16</sup>

12. See Executive Order 12,287, promulgated as Mandatory Petroleum Price Regulations; Elimination of Newly Discovered Crude Oil Property Verification Requirements, 46 Fed. Reg. 11,804 (1981) (to be codified in 10 C.F.R. § 212.)

13. 479 F. Supp. 536 (D.N.M. 1979).

14. Form 5-157 (July, 1964) and Form 5-157 (November, 1947).

15. In holding the secretary in breach of trust, the Court noted that financial and manpower limitations compound the difficulty of monitoring lease compliance. See J. Davenport, Assistant Secretary, Energy and Minerals, Davenport Memo in response to Sept. 7, 1978, order, made of record Mar. 12, 1979, but the Court did not consider such limitations as an excuse from trust responsibility. 479 F. Supp. 536, 547 (D.N.M. 1979).

16. "The administration of oil and gas leases is normally performed by the Geological Survey. Like other federal agencies, its ability to take all possible actions to pursue every possible avenue in every situation is limited. It must balance its use of resources against possible benefits. At the present time, the Geological Survey would require a considerable increase in funding and personnel to accomplish the above evaluation for every

For tribes wishing to develop oil and gas, or other reservation resources, leasing offers minimal involvement and responsibility for development, as well as limitations on tribal income and enforcement. In short, tribes have few alternatives under the leasing process. One alternative recommended by the court in *Supron* was the following:

I feel obligated to comment that the more appropriate remedy, were it available to the Tribe, would be the excision of the Secretary as the fiduciary through whom the Tribe is obligated to deal in its affairs with defendants-lessees. Plaintiff, like many other Tribes in recent times, has demonstrated its desire and ability to carry on business relations on its own, devoid of the paternalistic shroud in which it must be enveloped by the Secretary by virtue of the Tribe's legal status as a ward of the United States. It is Congress, however, and not the Court who is empowered to liberate the Indian Tribes from the protection imposed on them by the United States Government.<sup>17</sup>

This alternative could prove useful to tribes if it were selectively applied, e.g., only to tribal resource or business development, and if it did not do away with the necessary incentives still needed by tribes.<sup>18</sup> The problem that exists, however, is that Congress could take an "all or nothing" approach to "liberating" the tribes, which means termination. The view of the court may be well intended, but it fails to consider that termination has been tried and has been found to be a nonproductive enterprise.<sup>19</sup> Thus, another alternative needs to be found and considered.

#### *An Alternative: Joint Development of Reservation Oil and Gas Resources*

As illustrated in *Supron*, problems that arise from development based upon leasing often spring from the inherent adversary positions the parties must adopt in the lessor-lessee relationship. On the one hand, the oil and gas industry is attempting to adhere

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lease under its jurisdiction. The Geological Survey would, in effect, have to duplicate the technical staffs of the lessees to carry out this function fully." Davenport, *Id.*

17. 479 F. Supp. 536, 553 (D.N.M. 1979).

18. See text accompanying notes 9, 10 *supra*.

19. E.g., Wilkinson & Briggs, *The Evolution of the Termination Policy*, 5 AM. INDIAN L. REV. 139 (1977); Preloznik & Felsenthal, *The Menominee Struggle to Maintain Their Tribal Assets and Protect Their Treaty Rights Following Termination*, 51 N.D. L. REV. 53 (1974).

to its standards of economical and efficient development; on the other hand, the tribe is attempting to enforce its lease to ensure maximum development and income under the terms of the lease. The benefits that accrue for one party are often seen as exclusive in relationship to the benefits that accrue for the other party, i.e., a gain by one party is considered a loss by the other party.<sup>20</sup> An effective and efficient alternative to leasing must operate to eliminate or greatly reduce the adversary relationship between the tribe and the oil and gas industry, that is, tribal oil and gas resources must be developed for *mutual*, not mutually exclusive, benefit.

Although movement away from federal leasing implies development by a tribe in its individual capacity, this may not be the case. For strict self-development to occur a tribe must be willing to tie up its limited funds in the acquisition of petroleum technology, equipment, and expertise not possessed by the tribe. Such an extensive diversion of limited tribal funds from the governmental, social, and community programs of the tribe to a program of exploration and development would be far beyond the capabilities of most tribes. The high costs involved in the location and drilling of wells could quickly bankrupt even the most affluent tribes: drilling costs alone can range from \$400,000 to \$1.5 million per well, depending upon the depth, the geology encountered, the need for directional drilling, etc. Thus, for tribes planning to develop under a program of strictly individual tribal development, the tribe should be prepared to develop more slowly and to accept substantial sacrifice.

Many of the obstacles encountered in strict self-development could be reduced or eliminated by joining with the oil and gas industry in developing tribal resources for mutual benefit. Under such a program of joint development each party could provide

20. "I believe it can fairly be said that the mistrust and suspicion on the part of both the Indian and non-Indian parties to lease negotiations constitute a significant obstacle to the development of natural resources of Indian lands by the private sector. Indians have on occasion expressed the sentiment that the white man has cheated the Indian for generations and that the present crop of industry representatives are attempting to separate the Indian from his natural resources at less than a fair price. Industry reacts to such charges with amazement and chagrin, conceding that while Robber Barons may have taken advantage of Indians 100 years ago, industry today is acting generously and in good faith and feels the Indians should not take out their resentment for ancient wrongs on the present management. The conclusion often reached is that no matter what kind of deal is offered to the Indians, they will never be satisfied." Ferguson, *Industry Problems With Emerging Tribal Roles*, in INSTITUTE OF INDIAN LAND DEVELOPMENT—OIL, GAS, COAL AND OTHER MINERALS 7 (Rocky Mtn. L. Fdn. 1976).

that which the other does not possess. The tribe could provide the proven or suspected oil and gas in place which would be clear in title and free of encumbrance, and the industry could provide the equipment, technology, expertise, and money required to extract the reservation resource from the land. The problem that arises under this mutual or joint approach to development concerns the difference in value between each party's "contribution" to the development effort. The industry, by providing all or most all of the money, hardware, and know-how, could find itself in a much less favorable position under joint development than under leasing. Thus, a tribe must be able to provide more than unencumbered oil and gas, which is no more than it provides in a leasing situation, if it wishes to achieve its developmental goals.

### *Nontaxable Status as an Aid to Tribal Self-Development*

The only attribute possessed by a tribe that could substantially increase its bargaining position with respect to joint development with the oil and gas industry is its nontaxable status<sup>21</sup> under the Internal Revenue Code.<sup>22</sup> This status directly affects a tribe's economic position by not diminishing tribal profits or income through the burden of federal income taxation. In addition, the possibility exists that a tribe could structure its joint development arrangement with the oil and gas developer in a manner that would allow the developer to utilize certain tax benefits not available to the tribe, while allowing the tribe to increase its income and control over reservation oil and gas development. This possibility has been suggested by one commentator:

Indian tribes are exempt from federal income taxation as well as state income and resource taxes. As a result, any energy company contemplating the exploitation of reservation resources should consider the advantages of a project format that would allow the company to share a portion of available tax savings. Substantial tax savings can be achieved through careful structuring of the venture to spread the tax exempt tribal immunity over all or part of the project. As an alternative, a project can be structured under the tax exempt status so the

21. See text accompanying note 10, *supra*.

22. Unless otherwise indicated, all references are to the Internal Revenue Code of 1954 and the Treasury Department Regulations, as amended.

taxable partner has a disproportionate percentage of the operation's federal and state tax write-offs.<sup>23</sup>

If the commentator's unsupported assertions are valid, a tribe's nontaxable status could provide the basis for a tribal program of development that would benefit all parties. These benefits could take the following form:

(1) the promotion of tribal responsibility for self-government through the use of nontribal technology and funding in the exploration and development of reservation resources, and the accomplishment of the tribal goals of increasing control over reservation development, thus maximizing income from development and minimizing impact on the tribal environment and culture;<sup>24</sup>

(2) the creation of a favorable federal income tax environment for oil and gas developers and investors; and,

(3) the reduction of federal financial and oversight responsibility for tribal support and development. The overall effect of such a nontaxation-based program of development would be a tribe's acceptance of responsibility for its own growth, development, and economic security, and a shifting of some of the financial and developmental burden from the federal government to the private sector.

Notwithstanding the general attractiveness of a nontaxation-based joint development program, before such a program could be initiated several basic issues need to be examined to determine whether it is a conceptually practical alternative. To make this determination, the following must be considered: (a) whether a tribe truly exists as a nontaxable entity, and, if it does, (b) whether a tribe's nontaxable status could be used to achieve its development goals or objectives, and, if it can, (c) in what manner could the tribe's nontaxable status be applied to accomplish the beneficial results sought by a joint development program.

### *Nontaxation of Tribes Under Federal Income Tax Law*

“When one examines the treaties made between the United States and the Indian nations in search of a provision similar to

23. Israel, *New Opportunities for Development on Indian Reservations*, 32 MINING ENGR 651, 653 (1980).

24. The stated purpose and scope of the Proposed Regulations for reservation oil and gas development adopt similar goals for development. See Proposed Regulation, *supra* note 1, to be codified at 25 C.F.R. § 182.1(a).



the following: 'Nor shall said Indian Tribe, or Indians severally nor their property, real or personal, ever be liable to taxes of any kind . . .' he finds it missing."<sup>25</sup> This apparent absence of express, unambiguous authority upon which Indian nontaxable or tax-exempt status can be based has created some confusion as to the tax status of individual Indians and tribes. This examination does not concern the federal tax status of individual Indians, who are subject to federal income taxation,<sup>26</sup> unless exempted by treaty, agreement, or act of Congress,<sup>27</sup> or unless their income is derived directly from restricted allotted land held in trust by the United States.<sup>28</sup> In addition, this inquiry does not concern the taxation of tribes by the state.<sup>29</sup> The focus of this examination rests solely upon a tribe's status in relation to the Internal Revenue Code.

### *Authority for Tribal Nontaxibility*

The sole express authority for the proposition that Indian tribes are not subject to the income tax provisions of the Code exists in

25. J. WHITE, *TAXING THOSE THEY FOUND HERE* 1 (1972).

26. I.R.C. § 1 imposed a tax upon the taxable income of individuals, which includes all income from whatever source derived. See I.R.C. §§ 61(a), 62 & 63(b). "The Act [Revenue Act of 1918] does not expressly exempt the sort of income here involved, nor a person having petitioner's status [not protected by the federal trust responsibility] respecting such income, and we are not referred to any other statute which does." *Choteau v. Burnet*, 283 U.S. 691, 694 (1930).

27. "We agree with the Government that Indians are citizens and that in ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens . . . . But we cannot agree that taxability of respondents in these circumstances is unaffected by the treaty, the trust patent or the Allotment Act." *Squire v. Capoeman*, 351 U.S. 1, 6 (1955). See also Rev. Rul. 54-456, 1954-2 C.B. 49.

28. See Rev. Rul. 56-342, 1956-2 C.B. 20, as amplified by Rev. Rul. 62-16, 1962-1 C.B. 7, which applies the *Capoeman* holding and interprets income derived directly from the land to include rentals, royalties, proceeds from natural resource sales, etc.. See also *Stevens v. Commissioner*, 452 F.2d 741 (9th Cir. 1971), which holds that the income derived directly from restricted land extends to federal land purchased on behalf of Indian individuals and held in trust; and Rev. Rul. 74-13, 1974-1 C.B. 14, which follows the holding in *Stevens*. But see *Superintendent of Five Civilized Tribes v. Commissioner*, 295 U.S. 418 (1935), which holds that income derived from reinvesting income directly derived from trust-allotted land is not tax exempt.

29. See *supra* note 9, which recites the basis for exemption of tribal royalty and production income from state taxation. See also *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973), where a tribal off-reservation ski business located on lands acquired in trust, under 25 U.S.C. § 465, and exempt from state taxation, was held not exempt from a non-discriminatory gross receipts tax when the Court stated that it would "not imply an ex-

Revenue Ruling 67-284,<sup>30</sup> which simply states: "Income tax statutes do not tax Indian tribes. The tribe is not a taxable entity."<sup>31</sup> Notwithstanding the clarity and generality of the revenue ruling, tribes and individuals who wish to rely upon the ruling should realize that revenue rulings are "limited in scope by the pivotal facts stated in the Revenue Ruling,"<sup>32</sup> and should not be relied upon "unless the facts and circumstances are substantially the same."<sup>33</sup> In Revenue Ruling 67-284, no facts or circumstances were presented; thus, the statement should be considered as a conclusion of law and statement of policy by the Internal Revenue Service. The ruling does not define "tribe" within the application of the ruling. Such an omission is not unusual because "[n]either Congress nor the Executive Branch has prescribed any standardized definition for either the term 'Indian' or 'Indian tribe' in terms of the special federal relationships with Indians."<sup>34</sup> The concept of "tribe" has been narrowed in certain situations: "federal jurisdiction to authorize or secure immunities [from state, and possibly federal law] . . . does not exist except with respect to persons or entities which are 'Indians' or 'Indian Tribes,' respectively, in the political sense as acknowledged by the United States."<sup>35</sup> Thus, the term "tribe" in the ruling could, and probably does, refer to a tribe in the "political sense" which would mean it applies to the tribe as a government or to the governmental body of the tribe. The effect of applying such a definition to a joint development program would be that the tribal government, and not a separate tribal organization or group, must be the entity involved in the development of reservation resources. Otherwise tribal development could fall beyond the ambit of non-taxability under Revenue Ruling 67-284.

Finally, individuals or tribes planning to rely upon the ruling should be cognizant of the actual tribal tax status recognized by the Service. Some commentators have described tribes as being "exempt from federal income taxation,"<sup>36</sup> or have interpreted

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pansive immunity from ordinary income taxes that businesses throughout the State [were] subject to." *Id.* at 157.

30. 1967-2 C.B. 55.

31. *Id.* at 58.

32. Rev. Proc. 72-1, 1972-1 C.B. 693, 694.

33. *Id.* at 694-95.

34. *United States v. Washington*, 476 F. Supp. 1101, 1103 (W.D. Wash. 1979).

35. *Id.* at 1111.

36. See text accompanying note 23, *supra*.

Revenue Ruling 67-284 as an "exemption from taxation by the national government."<sup>37</sup> These characterizations of tribal tax status as based upon some form of "exemption from taxation" have not accurately construed the language of the ruling. "Exemption from taxation" has been defined by one source as follows:

In the broad sense, all property not taxed; in a narrower sense, the grant of immunity, express or implied, to particular persons or corporations, or to persons or corporations of a particular class, from a tax upon property or an excise which persons and corporations generally within the same taxing district are obliged to pay.<sup>38</sup>

Any characterization based upon an "exemption from taxation" would imply (1) that a tribe was subject to taxation, and (2) that all or a portion of the tribe or its income has been rendered immune from taxation by a statutory grant, whether express or implied. Such an interpretation does not follow the language of the ruling.

The ruling states in clear and express language that tribes are not subject to the income tax statutes and that they are not "taxable entities." This means that tribes are not "tax exempt" but are "nontaxable," i.e., tribes never were and are not now subject to any of the provisions of the Code. The importance of this distinction rests upon the effect of tax exemptions: such exemptions are generally narrow in scope and application,<sup>39</sup> and because tax exemptions are based upon a grant of immunity their existence is more tenuous, being subject to modification or extinguishment by the granting body or the courts.<sup>40</sup> On the other hand, the status of federal "nontaxation" broadly extends to all tribes existing as federally recognized political entities, and it is not limited by statute or decree. In fact, the existence of such a nontaxable status, as indicated below, stems from the absence of any statutory authority to the contrary.

37. Fiske & Wilson, *Federal Taxation of Indian Income From Restricted Indian Lands*, 10 LAND & WATER L. REV. 63, 68 (1975).

38. BALLENTINE'S LAW DICT. 435 (3d ed. 1969). See also BLACK'S LAW DICT. 681 (4th ed. 1968).

39. See notes 28, 29 *supra*.

40. See, e.g., *Washington v. Confederated Tribes of Colville Reservation*, 400 U.S. 905 (1980) (Indian commerce clause does not automatically bar all state taxation of matters affecting the economic and political interests of tribes); *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973).

*A Foundation for the Internal Revenue Service Ruling of Tribal Nontaxability Under the Internal Revenue Code*

Revenue Ruling 67-284 represents an official interpretation of federal tax law and policy by the IRS.<sup>41</sup> However, the absence of supporting analysis within the ruling has created some confusion or uneasiness among individuals and tribes who have relied or are planning to rely upon its conclusion of tribal nontaxability. Thus, an analysis of the federal Indian law applicable to tribes could serve to clarify the foundation upon which the ruling was based.

The ruling's conclusion of tribal nontaxability springs from and is consistent with the concept of tribal sovereignty and the rules of construction applicable to tribes. In *Worcester v. Georgia*,<sup>42</sup> the Court enunciated the basis for the sovereign status of tribes in relation to the federal government:

From the commencement of our government, Congress has passed acts to regulate trade and intercourse with the Indians; which treat them as nations, respect their rights, and manifest a firm purpose to afford that protection which treaties stipulate. All these acts . . . manifestly consider the several Indian nations as distinct political communities, having territorial boundaries, within which their authority is exclusive, and having a right to all the lands within those boundaries, which is not only acknowledged, but guaranteed by the United States . . . . The very term "nation," so generally applied to them, means "a people distinct from others." The Constitution, by declaring treaties already made, as well as those to be made, to be the supreme law of the land, has adopted and sanctioned the previous treaties with the Indian nations, and consequently, admits their rank among those powers who are capable of making treaties. The words "treaty" and "nation," are words of our own language, selected in our diplomatic and legislative proceedings, by ourselves, having each a definite and well-understood meaning. We have applied them to Indians, as we have applied them to the other nations of the earth. They are applied in the same sense.<sup>43</sup>

Although the language of *Worcester* would seem to indicate a level of tribal sovereignty on par with that of foreign nations, the

41. See generally Rev. Proc. 72-1, *supra* note 32.

42. 31 U.S. (6 Pet.) 515 (1932).

43. *Id.* at 556, 559.

Court had earlier indicated that sovereign tribes were not "foreign" but were "domestic dependent nations . . . [whose] relation to the United States resembles that of a ward to his guardian."<sup>44</sup> The Court has further described the "semi-independent position" of tribes as existing "not as States, not as nations, not as possessed of the full attributes of sovereignty, but as a separate people, with the power of regulating their internal and social relations, and thus far not brought under the laws of the Union or of the State within whose limits they reside."<sup>45</sup> And, as the Court has recently stated, "tribal sovereignty is dependent on and subordinate to only the Federal Government, not the States."<sup>46</sup> Thus, in a hierarchy of sovereign entities a tribe is more than a state but less than the United States.

Tribes possess all of the attributes of local self-government, but when exercising tribal functions and authority all such rights are "subject to the supreme legislative authority of the United States."<sup>47</sup> Or, as also stated by the Court, "Congress has plenary authority to limit, modify or eliminate the powers of local self-government which the tribes otherwise possess."<sup>48</sup> Prior to the passage of the Indian Appropriation Act of March 3, 1871,<sup>49</sup> Congress defined its relationships with Indian tribes by treaties, but with the Act Congress terminated treaty-making with Indian tribes. The effect of this end to treaty-making has been described as follows:

[Passage of the Act] meant no more, however, than that after 1871 relations with Indians would be governed by Acts of Congress and not by treaty. [Citations omitted.] The change in no way affected Congress' plenary powers to *legislate* on problems of Indians. . . . Once ratified by Act of Congress the provisions of the agreements became law, and like treaties, the supreme law of the land.<sup>50</sup>

A canon of construction applicable to congressional Indian legislation requires that such legislation "be liberally construed,

44. *Cherokee Nation v. Georgia*, 30 U.S. (5 Pet.) 1, 17 (1831).

45. *United States v. Kagama*, 118 U.S. 375, 381-82 (1885).

46. *Washington v. Confederated Tribes of Colville Reservation*, 447 U.S. 134, 154 (1980).

47. *See Talton v. Mayes*, 163 U.S. 376, 384 (1895).

48. *Santa Clara Pueblo v. Martinez*, 436 U.S. 49, 56 (1977).

49. Codified at 25 U.S.C. § 71 (1970).

50. *Antoine v. Washington*, 420 U.S. 194, 203-204 (1975) (emphasis in original).

[with] doubtful expressions being resolved in favor of the Indians.”<sup>51</sup> And, where Indian or tribal rights or immunities are involved, the United States Supreme Court, in applying this rule has recognized that “[a] congressional determination to terminate [a tribe, or its rights or immunities,] must be expressed on the face of the Act or be clear from the surrounding circumstances and legislative history.”<sup>52</sup> Thus, where federal legislation would extinguish any immunity or right, then not only must the Act be construed liberally with doubtful language resolved in favor of the tribe, but the language must clearly express or manifest a congressional purpose to extinguish the immunity or right.

This requirement of a clear expression or manifestation from Congress has created some confusion when applied to statutes of “general applicability,”<sup>53</sup> which would include the Internal Revenue Code. The applicable rule is that “general Acts of Congress apply to Indians as well as to all others in the absence of a clear expression to [the] contrary.”<sup>54</sup> Or, for instance, as applied to the Internal Revenue Code’s taxation of individual Indians who are not protected by the trust responsibility of the federal government:

The intent of Congress was to levy the tax with respect to all residents of the United States and upon all sorts of income. The act does not expressly exempt the sort of income here involved [income distributed from tribal royalty income], nor a person having petitioner’s status [held a certificate of competency] respecting such income, and we are not referred to in any other statute which does. . . . The intent to exclude must

51. *Alaska Pacific Fisheries v. United States*, 248 U.S. 78, 89 (1918). See also *Choate v. Trapp*, 224 U.S. 665, 675 (1912).

52. *Mattz v. Arnett*, 412 U.S. 481, 505 (1973); *Bryan v. Itasca County*, 426 U.S. 373 (1976). The Court has also recognized that “Indians stand in a special relation to the federal government . . . unless the Congress has manifested a clear purpose to terminate immunity and [consider] Indians as part of the general community.” *Oklahoma Tax Comm’n v. United States*, 319 U.S. 598, 614 (1943).

53. In *Elk v. Wilkins*, 112 U.S. 94 (1884), the Court stated that, “General acts of Congress did not apply to Indians, unless so expressed as to clearly manifest an intention to include them.” *Id.* at 99-100. But, in *Blackbird v. Commissioner*, 38 F.2d 976 (10th Cir. 1930), the rule announced in *Elk* was undermined by the Court’s view that *Cherokee Tobacco*, 78 U.S. (11 Wall.) 616 (1870), upon which *Elk* was founded, had been “nullified” by the Supreme Court in *United States v. Forty-Three Gallons of Whiskey*, 108 U.S. 491 (1883), because the decision was not made by a majority of the Court. See generally *GETCHES, ROSENFELT & WILKINSON, FEDERAL INDIAN LAW*, 200-204 (1979).

54. *FPC v. Tuscarora Indian Nation*, 362 U.S. 99, 120 (1970).

be definitely expressed, where, as here, the general language of the Act laying the tax is broad enough to include the subject matter.<sup>55</sup>

Although "express" congressional intent is required to exclude a tribe from the application of a general act of Congress, thus creating a tribal immunity, it is also required to extinguish a tribal immunity or right. Thus, confusion often remains where a tribe is not expressly excluded from a general act and also is not expressly stripped of its rights or immunities.

In such a situation, where conflict exists between traditional rules of construction, the courts and administrative agencies have examined the scope of a statute of general applicability in the context of (1) the federal trust responsibility, and (2) the effect on tribal sovereignty. The application of general acts of Congress to tribes or individual Indians has been allowed where the application did not breach the trust responsibility of the United States nor affect the sovereignty of the tribe within the boundaries of the reservation.<sup>56</sup> On the other hand, the application of such general statutes or acts has not been allowed where the application would breach or erode federal trust responsibility or infringe upon the sovereignty of tribal government.<sup>57</sup> Thus, as a general

55. *Choteau v. Burnet*, 283 U.S. 691, 694, 696 (1931).

56. *E.g.*, statutes of general applicability have been allowed in the following circumstances: (1) in *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973), the Court held that a business enterprise operated outside of the reservation was subject to the state's general gross receipts tax; (2) in *FPC v. Tuscarora Indian Nation*, 362 U.S. 99 (1970), the Court held that nontrust fee land owned by the tribe was subject to the federal eminent domain power and could be condemned by a federal agency; (3) in *Navajo Tribe v. NLRB*, 288 F.2d 162 (D.C. Cir. 1961), the court held that a non-Indian employer operating on the reservation was subject to the National Labor Relations Act, but that the Act had a doubtful effect on the tribe; and (4) in *Choteau v. Burnet*, 283 U.S. 691 (1930), held that income derived from trust income and distributed to an individual Indian not under federal trust protection, was subject to federal income taxation.

57. *E.g.*, The application of general statutes or acts have not been allowed in the following circumstances: (1) In *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973), the Court held that off-reservation land held in trust was not subject to the general property tax of the state; (2) in *FPC v. Tuscarora Indian Nation*, 362 U.S. 99 (1970), the Court indicated that application of federal eminent domain powers did "not breach the faith of the United States, or any treaty or other contractual agreement" because the lands were nontrust fee lands; (3) in *Fort Apache Timber Co.*, 226 N.L.R.B. 503 (1976), the National Labor Relations Board held that the sovereign status of a tribal government over its affairs within the reservation excluded it from the definition of "employer" under the N.L.R.A.; and (4) in *Stevens v. Commissioner*, 452 F.2d 741 (9th Cir. 1971), the Court held that income derived directly from land held in trust solely for the benefit of an individual Indian was not subject to federal income tax.

rule, where application of a statute of "general applicability" would infringe upon the sovereignty of tribal government within the reservation, or would extinguish or erode the rights or immunities of the tribe or its members, such an application would require a clear manifestation or expression from Congress that such action was intended.

Therefore, in order to subject a sovereign tribe protected under the trust responsibility of the federal government to the provisions of the Internal Revenue Code, and thus make the tribe subject to the burden of taxation, application of the general rule would require a clear, unambiguous expression or manifestation from Congress that such action was intended. No such congressional manifestation or expression exists.<sup>58</sup> Thus, the conclusion of the Service in Revenue Ruling 67-284, that "[i]ncome tax statutes do not tax Indian tribes [, and that t]he tribe is not a taxable entity,"<sup>59</sup> is valid and correct.

### *Tribal Use of the Federal Nontaxable Status in Tribe-Owned Reservation Enterprises*

Accepting the validity and scope of tribal nontaxation for

58. Notwithstanding the absence of express or manifest congressional intent to subject tribes to federal income taxation, the enactment of the Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 4991(b)(2), § 4994(d), 94 Stat. 229, has blurred the "nontaxable" status of tribes which "produce" oil from trust and restricted mineral interests by expressly exempting federally recognized tribes from "windfall profit" taxation. This blurred view of the tribal tax-free status is reflected in the following: "The House did not specifically exempt oil produced by Federally recognized Indian tribes. However, various court decisions and Internal Revenue Service rulings hold income from Tribal Trust Lands to be exempt from income tax in the absence of a clear Congressional intention to impose a tax. Thus, it is unclear whether the courts and Internal Revenue Service would interpret the House bill as taxing tribal trust oil production." S. REP. No. 394, 96th Cong., 1st Sess. 61 (1979). The "court decisions and [IRS] rulings" referred to in the report appear to be those involving a tribal member's receipt of a share of income or royalty from tribal leases or agreements. *E.g.*, *Blackbird v. Commissioner*, 38 F.2d 976 (10th Cir. 1930); Rev. Rul. 58-320, 1958-1 C.B. 24. Congress could have relied upon or incorporated by reference Rev. Rul. 67-284, 1967-2 C.B. 55, to maintain the clarity of a tribe's federal nontaxable status if it wished tribes to remain wholly nontaxable under the IRC. But, by expressly including tribes within the application of the windfall profit tax Congress has undermined and blurred the conclusion of Rev. Rul. 67-284, thus making it less reliable than before passage of the Act. For a narrow portion of their income, tribes are currently subject to taxation with an exemption granted for such income derived from mineral interests held in trust or restricted status and in which the tribe has an "economic interest" on Jan. 21, 1980.

59. See text accompanying note 30, *supra*. The I.R.C. imposed taxation only upon individuals, estates, and trusts under § 1, and upon corporations under § 11.



federal income tax purposes, the next question is whether a tribe could use its federal nontaxable status to achieve its development goals or objectives.

This question was recently considered, in part, in an analogous situation involving state taxation. In *Washington v. Confederated Tribes of the Colville Indian Reservation*,<sup>60</sup> the state tax exemption of a tribe was examined in the context of the tribal power to impose a cigarette sales tax upon non-Indians within the reservation and the tribal preemption of concurrent state taxation. In holding that the state of Washington could impose its tax on cigarette purchases by nontribal individuals, the Court discussed some limitations on the tribal use of its state tax exemption:

It is painfully apparent that the value marketed by the smoke-shops to persons coming from outside is not generated on the reservations by activities in which the Tribes have a significant interest. [Citations omitted.] What the smokeshops offer these customers, and what is not available elsewhere, is solely an exemption from state taxation. The Tribes assert the power to create such exemptions by imposing their own taxes or otherwise earning revenues by participating in the reservation enterprises. If this assertion were accepted, the Tribes could impose a nominal tax and open chains of discount stores at reservation borders, selling goods of all descriptions at deep discounts and drawing custom from surrounding areas. We do not believe that principles of federal Indian law, whether stated in terms of pre-emption, tribal self-government, or otherwise, authorize Indian tribes thus to market an exemption from state taxation to persons who would normally do their business elsewhere.<sup>61</sup>

The clear concern of the Court was the possible "marketing" of a state tax exemption by the tribe in order to create an unfair advantage for a reservation business over nonreservation businesses. But of apparent greater concern to the Court was the mechanism employed by the tribe to encourage tribal business enterprises—the preemption of all state taxation on a transaction which the state was authorized to tax,<sup>62</sup> thus allowing the non-tribal customers to purchase the product free of any state tax levy. Although such a situation could not occur under an oil and gas joint development program for federal income tax purposes,

60. 447 U.S. 134 (1980).

61. *Id.* at 155.

62. See *Moe v. Salish & Kootenai Tribes*, 425 U.S. 463 (1976) (state taxation of on-reservation cigarette sales to non-Indian purchasers held valid).

the question remains whether a tribe can use its federal nontaxable status to promote its development goals under the Court's rationale in *Colville*. An examination of the Court's rationale should serve as an answer to this issue.

Setting aside the disparate foundations in law for tribal state tax exemptions and tribal federal nontaxation, and focusing on the Court's rationale, a "general rule" for tribal use of its tax-free status can be constructed. This "rule" derived from the language of the Court, could take the form of the following: If the "value" of a product sold to nontribal individuals on a reservation is derived solely from a tax-exempt (or nontaxable) tribal status, and is not produced or generated on the reservation by activities in which a tribe has a significant interest, then a tribe does not have the authority to employ such a tax-free status to create a commercial advantage for tribal business over nontribal business.

An application of this "rule" to a joint oil and gas development program makes apparent a significant difference between the tribe's use of its tax-exempt status in *Colville* and the use of the tribal nontaxable status in the program, i.e., no competitive business advantage is sought nor would be realized by the tribe as a result of the program. The tribe's development of its oil and gas would not be at the expense or detriment of others in the oil and gas industry, but would be more in the form of cooperation with the industry. The only advantages that could be realized by the tribe would be an achievement of the tribal goals of increased control and income from development and a decreased impact on the tribal culture and environment.

As indicated by the "rule," the Court considered two elements essential in determining whether the tribe's use of its tax-exempt (or nontaxable) status was allowable: (1) the sole reason for transacting business with the tribe was based upon a shift of tax-free status from the tribe to the nontribal participant, and (2) the subject of the transaction was produced or generated on the reservation by activities in which the tribe had a significant interest. Applying these criteria to the joint development program indicates that the "rule" in *Colville* would not disallow a tribe's use of its federal nontaxable status for such development purposes. First, the tribe could not shift its nontaxable status to the nontribal participant. The tribe in *Colville* was able to attempt such a shift because of its conceptually "higher level" of sovereignty<sup>63</sup> which

63. See text accompanying note 46, *supra*.

allowed it to claim that state taxes or laws had been preempted by tribal law<sup>64</sup> or federal law.<sup>65</sup> But, no such claim can be made against the federal government whose sovereignty exceeds that of the tribe. Moreover, any "shifts" that would occur between the participants in the joint development program would be only those allowed under the Internal Revenue Code, and any effect on the nontribal participant should not be violative of the Code. Second, the subject matter of the transaction, the oil and gas in place under the reservation, exists as a vital interest of the tribe, which is reflected in the desire of most tribes to become actively involved in the actual production of their reservation resource. Thus, under the criteria expressed in *Colville*, a tribe's use of its nontaxable status should be allowed.

Though remote, another possible limitation could exist on a tribe's use of its federal nontaxable status under the guise of the "overriding federal interest" doctrine. This doctrine, which was discussed in *Colville*,<sup>66</sup> was described in *Oliphant v. Suquamish Indian Tribe* as follows: "Upon incorporation into the territory of the United States, the Indian tribes thereby come under the territorial sovereignty of the United States and their exercise of separate power is constrained so as not to conflict with the interests of this overriding sovereignty."<sup>67</sup> Under this doctrine one could argue that a tribe's use of its nontaxable status impinges upon the United States' sovereign right to levy its income tax under the IRC by reducing the lawful tax owed by the nontribal participants. Proponents of such an argument would have to show that when tribes submitted to the overriding sovereignty of the United States they also surrendered their right to enter into any agreements that might affect federal taxation, even though the tax liability and the decisions affecting such liability are the sole responsibility of the taxpayer and are beyond the power of the tribe. Such an argument would have greater impact if the tribe's use of its nontaxable status totally removed the possibility of tax liability, rather than just possibly affecting such liability.

64. See *Williams v. Lee*, 358 U.S. 217, 220 (1959) (states cannot infringe upon the right of reservation Indians to make their own laws and be ruled by them.)

65. See, e.g., *Central Machinery Co. v. Arizona Tax Comm'n*, 448 U.S. 160 (1980) (comprehensive federal regulation of traders on a reservation left no room for the additional burden of state taxation).

66. See 447 U.S. 134 (1980) (tribal taxation of cigarette sales does not conflict with any overriding federal interest).

67. *Oliphant v. Suquamish Indian Tribe*, 435 U.S. 191, 209 (1978) (tribal incarceration of non-Indians in conflict with overriding federal interests).

The effect, if any, of a tribe's nontaxable status occurs as a result of its primary concern for the development of reservation resources. It would in no way affect the right of the United States to impose or enforce its income tax upon its citizens. In actuality, there appears to be little or no possibility that a tribe's tax status, in the context of reservation development, could frustrate the federal interest in obtaining revenue.

Although a judicial review would probably be necessary to resolve this question, the possibility clearly exists that a tribe's use of its federal nontaxable status as a means of achieving its developmental goals or objectives would not run afoul of a rule such as the one presented in *Colville*, and that it should not tread upon an overriding federal interest. Such use exists as only one factor among many that a tribe must consider if it is to accept and increase its responsibility for the development of reservation resources. Because such use could be of substantial benefit to a tribe and the nontribal participants, however, it would be in the best interest of both to seek some form of clarification upon which they could rely before implementing the development project. Thus, a tribe, in the context of a joint development program, should seek a ruling from the Service as to the status of such a program for federal income tax purposes.<sup>68</sup>

*Effect of a Tribe's Nontaxable Status on a Joint Development Program of Reservation Oil and Gas Resources*

Notwithstanding the fact that whether a tribe can use its federal nontaxable status within the context of reservation resource development remains a question to be clarified by the courts or Congress, but accepting the possibility that such use would not be found objectionable, the question remaining is in what manner, if any, could a tribe employ its status of nontaxability to accomplish the beneficial effects sought by a joint program for the development of tribal oil and gas?<sup>69</sup> An attempt to answer this question involves the examination of two interlocking issues: (1) what kind of structure should a joint development program adopt that would take into account a tribe's federal nontaxable status, and (2) what would be the possible effect of such a structure on the tribal and the nontribal participants?

To premise such an examination, several basic and unalterable

68. See I.R.C. § 7805; Income Tax Reg. § 301.7805-1; and, Internal Revenue Service Manual—Admin., P(11)23-P(11)47, P(11)68-P(11)75 (CCH).

69. See text preceding and following note 24, *supra*.

principles should be considered. First, even though tribes are not subject to the provisions of the IRC,<sup>70</sup> nontribal participants are subject to and governed by its provisions; thus the structure of the joint development program must necessarily comply with the provisions of the Code and applicable case law. Second, participant-taxpayers have the right to decrease the amount of their tax liability or altogether avoid such liability by any lawful means,<sup>71</sup> and they are generally free to structure their business affairs to be in their best interests, including the lawful structuring of their affairs to minimize their tax burden.<sup>72</sup> Third, the burden of the participants' tax liability is dependent upon the substance, not the form, of their transaction,<sup>73</sup> which means that the form selected for a transaction must have economic reality<sup>74</sup> and not exist as a mere sham.<sup>75</sup> Thus, an examination of the structures available to a joint development program not only must focus on potential benefits but also must ensure that such structures are firmly grounded in economic substance under the federal tax laws.

### *The Structure of a Joint Development Program*

The range of structures that could be employed by a tribe in a joint program for development are limited because such structures must be consistent with and maintain a tribe's sovereign status, allow a flexible relationship to exist between the parties, and provide maximum tax advantages to the nontribal participants. These minimum basic requirements would exclude the traditional corporate structure for the following reasons: (1) tribal sovereignty would be undermined because a tribe, to the extent of its involvement in the corporation, would have to submit to the jurisdiction of the state that granted the charter of incorporation;<sup>76</sup> (2) a tribe would indirectly render its income subject

70. Excluding §§ 4991(b)(2) and 4994(d) of the Crude Oil Windfall Profits Tax of 1980, *supra* note 58.

71. *See, e.g.*, *Knetsch v. United States*, 364 U.S. 361 (1960).

72. *See, e.g.*, *Commissioner v. First Security Bank of Utah*, 405 U.S. 394 (1972).

73. *See, e.g.*, *Commissioner v. Hansen*, 360 U.S. 446 (1959).

74. *See, e.g.*, *Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977).

75. *See, e.g.*, *Davis v. Commissioner*, 585 F.2d 807 (6th Cir. 1978), *cert. denied*, 440 U.S. 981 (1979).

76. *See, e.g.*, A.B.A.-A.L.I. Model Bus. Corp Act (rev. 1969). The corporation would have to file articles of incorporation with the state (§ 55), and maintain an office and agent within the state (§ 12) for service of process (§ 14). Note: Even if the tribe enacted its own incorporation laws, the state could probably retain at least concurrent

to federal income taxation,<sup>77</sup> while the nontribal participants would be subject to double taxation;<sup>78</sup> and, (3) a corporate form of structure would offer little flexibility to the parties to adjust for changing circumstances.<sup>79</sup> Almost the same reasons would exclude a Subchapter S corporation as a possible joint development structure.<sup>80</sup>

At the opposite end of the range of possible structures is the joint venture.<sup>81</sup> This form of structure would offer the flexibility required by the parties and would not submit the tribe to the jurisdiction of the state. For the purpose of federal income taxation, a joint venture is included within the definition of "partnership"<sup>82</sup> and is governed by the provisions of Subchapter K.<sup>83</sup> Under these provisions, partners are individually liable for their income tax.<sup>84</sup> Each partner is required to take into account its "distributive share" of income, gain, loss, deduction, or credit, whether or not distributed to it, in order to determine tax liability.<sup>85</sup> What consti-

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jurisdiction because of the involvement of the nontribal participants. *Cf.* *Oliphant v. Suquamish Indian Tribe*, 435 U.S. 191 (1978), or could require the tribal corporation to register as a foreign corporation (§ 112).

77. Under I.R.C. § 11, the corporation would be subject to federal income taxation on corporate income and on accumulated earnings, I.R.C. § 531, and the nontribal participants, but not the tribe, would again be taxed upon distribution of corporate income. The income received by the tribe would remain subject to taxation at the corporate level if not at the individual level.

78. *Id.*

79. *See, e.g., A.B.A.-A.L.I.*, §§ 58-70, note 76, *supra* (amendment of articles of incorporation).

80. *See* I.R.C. §§ 1371-1379.

81. "The legal relationship known as a joint venture has been defined as a 'special combination of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation,' and also as 'an association of persons to carry out a single business enterprise for profit.'" *Beck Chem. Equip. Corp. v. Commissioner*, 27 T.C. 840, 848-49 (1957).

82. "Partnership" includes "a syndicate, group, pool, joint venture, or other unincorporated organization through . . . which any business, financial operation, or venture is carried on . . . [And, it] is broader in scope than the common law meaning . . . and may include groups not commonly called partnerships. See section 7701(a)(2)." Reg. § 1.761-1(a). "Whether parties have formed a joint venture is a question of fact to be determined by reference to the same principles that govern . . . whether persons have formed a partnership . . . for tax purposes . . . [T]he essential question is whether the parties intended to, and did in fact, join together for the present conduct of an undertaking or enterprise." *Luna v. Commissioner*, 42 T.C. 1067, 1077 (1964).

83. *See* I.R.C. §§ 701-71.

84. I.R.C. § 701. *See also* I.R.C. § 703 (computation of income and deduction, and elections affecting taxable income made at the partnership or individual level).

85. Income Tax Reg. § 1.702-1(a).

tutes a partner's distributive share of a joint venture is determined either by the provisions of the joint venture agreement,<sup>86</sup> or by the proportionate interest in the joint venture owned by the partner where the agreement is silent as to the partner's distributive share, or where a special allocation of income, gain, loss, etc., in the agreement lacks "substantial economic effect."<sup>87</sup> Because each partner is taxed individually, use of the joint venture form of structure would allow a tribe to retain wholly the federal nontaxability of its distributive share of joint venture income. It could also allow a nontribal participant lawfully to decrease his tax liability by means of "special allocations" authorized under the joint venture agreement, which could have a "substantial economic effect."<sup>88</sup> It is through such allocations in the agreement that the tribe and the nontribal participants would attempt to shift the benefits and burdens of the joint venture for their mutual benefit.

*The Effects of Structure: Limitations Encountered in  
a Joint Development Program Employing a  
Traditional Joint Venture Form*

*Section 704(b)(2) special allocations under the  
test for "substantial economic effect"*

Other than some incipient difficulties facing the development of trust property,<sup>89</sup> one of the initial questions with which a joint development program must contend is whether the special allocation made pursuant to the joint venture agreement exerts a "sub-

86. I.R.C. § 704(a).

87. I.R.C. § 704(b), *as amended* by the Tax Reform Act of 1976, see note 114, *infra*.

88. Income Tax Reg. § 1.704-1(b)(2) describes "substantial economic effect in the following: "whether an allocation has 'substantial economic effect,' that is, whether the allocation may actually affect the dollar amount of partners' shares of the total partnership income or loss independently of tax consequences . . . ."

89. The Office of the Solicitor, Department of Interior, has expressed its view in an undocumented opinion that, under current law, the Secretary of the Interior does not possess the authority to approve partnership-joint venture agreements which vest an economic interest in trust property in nontribal or non-Indian individuals or organizations. Notwithstanding numerous secretarial approvals of such agreements prior to this opinion, the Department of Interior has proposed legislation to remedy this technical oversight. Interview with Phillip S. Deloria, Director, American Indian Law Center (formerly Deputy Assistant Secretary, Indian Affairs), in Albuquerque, N.M. (Feb. 13, 1981). This "problem" should be easily overcome by a contribution of a leasehold interest in trust property rather than of trust property itself.

stantial economic effect”<sup>90</sup> and applies to all special allocations, i.e., allocations that vary from the general allocation of profit and loss in the joint venture,<sup>91</sup> and which are expressed, orally or in writing, in the original agreement or in a modification to the agreement.<sup>92</sup> What constitutes the elements or substance of the test has been slow in evolution and the subject of much commentary.<sup>93</sup>

The Service has provided little guidance as to the substance or scope of the test<sup>94</sup> beyond the description provided in the regulations,<sup>95</sup> which one commentator has interpreted as follows:

90. The “substantial economic effect” test was added to I.R.C. § 704(b)(2) by the Tax Reform Act of 1976. Prior to its codification it was the principal test employed to determine if an allocation’s “principal purpose” was the “avoidance or evasion” of a tax, which was the previous § 704(b)(2) standard. The phrase first appeared in the Senate Finance Committee Report on the 1954 Code, “and was apparently added . . . to allay fears that special allocations of income or deductions would be denied effect in every case where the allocation resulted in a reduction in the income tax liabilities of one or more of the partners. The statement is an affirmation that special allocations are ordinarily to be recognized if they have business validity apart from their tax consequences.” *Orrisch v. Commissioner*, 55 T.C. 395, 400, 401 (1970). The test is to be applied “as presently interpreted by the regulations and case law.” S. REP. No. 938, 94th Cong., 2d Sess. 100 (1976).

91. Under I.R.C. § 702(a)(8), a partner’s general allocation of profits and losses in his distributive share of profits and losses stated in the joint venture agreement. Items which can be specially allocated to one or more partners are those items listed in §§ 702(a)(1) through 702(a)(7), which must be separately stated by a partner in computing his tax liability, plus any item listed in Income Tax Reg. § 1.702-1(a)(8)(i), e.g., intangible drilling costs, which requires that § 702(a)(8) items, e.g., depreciation and depletion, must be separately stated also if they are subject to a special allocation.

92. I.R.C. § 76; Income Tax Reg. § 1.761-1(c). *See, e.g., Kresser v. Commissioner*, 54 T.C. 1621 (1970) (oral modification of agreement held invalid because not made according to terms of the agreement). “Such modification[s] relate back to the beginning of the partnership year in which the modification occurs. *See David A. Foxman*, 41 T.C. 535, 554 . . .” *Id.* at 1628.

93. *See, e.g., Cowan*, 283 T.M., *Partnerships—Distributive Shares—Disallowance of Special Allocations*: A. WILLIS, PARTNERSHIP TAXATION § 25.03A (2d ed. Supp. 1980); Kamin, *Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976*, 30 TAX LAW. 667 (1977); Houghton & Houghton, *Special Allocations: Is the Service Giving New Meaning To “Substantial Economic Effect”?* 28 O. & G. TAX Q. 1 (1979) [hereinafter cited as Houghton & Houghton]; Comment, *Partnership Allocations and Capital Accounts: A Technical Advice Memorandum as Administrative Minefield*, 35 TAX LAW. 441 (1980).

94. The Service will not issue an advance ruling or determination letter on whether an allocation of income, gain, loss, deduction or credit, or an item thereof, has substantial economic effect. Rev. Proc. 74-22, 1974-1 C.B. 496, superseding Rev. Proc. 74-22, 1974-2 C.B. 16, and Rev. Proc. 72-9, 1972-1 C.B. 719.

95. *See note 87 supra.*



Thus, it is possible to tell in most cases whether a special allocation has an economic effect by asking whether the total number of dollars a partner is entitled to receive (other than by way of tax deductions and the like) is increased or decreased by the special allocation, i.e., would he receive the same amount of dollars if there were no special allocation. If he would receive the same amount of dollars, the allocation does not have an economic effect.<sup>96</sup>

Early decisions involving special allocations either did not provide an analysis of substantial economic effect,<sup>97</sup> or resolved the issue without reference to the test, e.g., finding the allocation more closely resembled a "loan" rather than "a true modification or readjustment of the partner's distributive shares . . . ."<sup>98</sup>

The form of analysis presently employed by the courts and the Service to determine substantial economic effect involves an examination of the effect of the special allocation on the capital account<sup>99</sup> of the partner receiving the allocation. The framework for this analysis was established by the court in *Orrisch v. Commissioner*,<sup>100</sup> when it announced the following principles for determining the existence of a substantial economic effect: (1) as a general rule, the economic burden created by a special allocation must be borne by the party receiving the allocation, and to reflect this burden, the special allocation must operate to increase or decrease the capital account of the party receiving the allocation;<sup>101</sup> (2) such a party's capital account should be adjusted to account for any disparity between partners' accounts either by making a contribution to the partnership, or by proportionately reducing his share of partnership assets at liquidation of the partnership;<sup>102</sup> and, (3) partners cannot use "prospective tax benefits

96. Cowan, *supra* note 93, at A-5.

97. See Rev. Rul. 68-139, 1968-1 C.B. 311 (special allocation of intangible drilling costs held to have substantial economic effect, without analysis).

98. *Kresser v. Commissioner*, 54 T.C. 1621 (1970).

99. The joint venture agreement establishes capital accounts, which usually consist of the partner's original investment plus any additional capital contributions and any accumulated profits, less any distributions in reduction of capital and any distribution of losses. See, e.g., 2 A. WILLIS, PARTNERSHIP TAXATION 318 app. (2d ed. 1976).

100. 55 T.C. 395 (1970), *aff'd per curiam*, 476 F.2d 502 (9th Cir. 1973) (disallowed special allocation of all depreciation to partner with excess income from other source, and where other partner could not use depreciation due to excess losses from other source).

101. 55 T.C. at 403.

102. *Id.* at 403-404.

. . . as the medium for equalizing their investments,"<sup>103</sup> i.e., their capital accounts. The court applied these principles and found that the special allocation did not "actually affect the dollar amount of the partner's shares of the total partnership income or loss independently of tax consequences," and thus did not have substantial economic effect within the meaning of Regulation § 1.704-(b)(2).

The basic analysis of *Orrisch* was applied in *Harris v. Commissioner*,<sup>104</sup> which affirmed the substantial economic effect of an "arm's-length" transaction in which all of the parties wished to "clearly delineate" their respective tax burdens, and which resulted in an "exact equivalence between the amount of loss and the economic effect as among the partners . . ." <sup>105</sup> In *Magaziner v. Commissioner*,<sup>106</sup> the court reaffirmed and simplified the *Orrisch* capital account analysis when it announced:

In other words, the partner who benefits from a special allocation of tax deductions must bear the entire economic cost [burden] of such deductions. Accordingly, if the allocation of an item of income or deduction to a partner is reflected in his capital account and the liquidation proceeds of the entity are distributed in accordance with the capital accounts, the allocation has substantial economic effect.<sup>107</sup>

The language of the court approving a special allocation resulting in "exact equivalence" or requiring a special allocation recipient to "bear the entire economic cost [burden]" of the allocation, has apparently spurred the Service to adopt the view that a special allocation must exert a dollar-for-dollar economic effect on the capital accounts at liquidation of a joint venture in order to have a "substantial economic effect."<sup>108</sup> This view, which has been the subject of commentary and criticism,<sup>109</sup> appears to be a move away from the concept of substantial economic effect ex-

103. *Id.* at 402, n.5.

104. 61 T.C. 770 (1974).

105. *Id.* at 786.

106. 47 T.C.M. (P-H) 867 (1978) (special allocation of depreciation denied).

107. *Id.*

108. Technical Advice Memorandum 7707260880A (July 26, 1977), discussed in Fed. Tax Coord. (RIA) 49 (Feb. 22, 1979). The letter ruling, while confined to the specific facts of the case presented, indicates the view of the Service in light of applicable law, regulations, and case precedent.

109. See Houghton & Houghton, and Comment, *supra* note 93.

pressed in the regulation, i.e., that an "allocation *may* actually affect" the partners' shares of income or loss,<sup>110</sup> toward a concept that an allocation *must* have a definite effect on the partners' shares at liquidation according to their capital account proportions irrespective of other considerations, e.g., risk of loss or the economic reality of the transaction,<sup>111</sup> or whether the allocation has a "business validity" consistent with the historical customs of the oil and gas industry.<sup>112</sup> Thus, under the decision of the courts and the interpretation of the Service, the test applied to determine the validity of a special allocation under IRC § 704(b)(2) appears to have become rigid in scope and strict in application.

*Limitation on deductions available to a joint venture to the "amount at risk" under section 465*

Prior to the enactment of the Tax Reform Act of 1976,<sup>113</sup> many high-income individuals were able to offset or eliminate their tax liability through investment devices commonly referred to as "tax shelters." The function of these devices has been described as follows:

[I]n general, they all allow taxpayers to offset certain "artificial losses" (that is, noneconomic losses, but losses which are available as deductions under the present tax laws) not only against the income from those investments but also against the taxpayer's other income, usually from his regular business or professional activity. A major purpose of these investments for most taxpayers is to reduce the tax liability on their regular income.<sup>114</sup>

And the basic elements of an oil and gas tax shelter have been described in the following:

The principal features of the oil and gas tax shelter included:

110. Note 88, *supra* (emphasis added). See Houghton & Houghton, *supra* note 93.

111. Houghton & Houghton, *supra* note 93, at 15-19.

112. See *supra* note 90 and Larson, *Distinctive Features of Oil and Gas Allocations Yielding Tax Benefits for Partners*, 49 J. TAX. 362, 366 (1978).

113. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified within various sections of 26 U.S.C.), as amended by Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, and the Technical Corrections Act of 1979, Pub. L. No. 96-222, 94 Stat. 194.

114. *Joint Comm. on Internal Revenue Taxation, Overview of Tax Shelters*, 94th Cong., 1st Sess., 2 (1975), reprinted in FED. TAXES (P-H) Rept. Bull. No. 48 (Nov. 6, 1975).

(1) the immediate deduction of intangible drilling and development costs; (2) the use of leverage through nonrecourse loans so that the limited partners are able to deduct expenses in excess of their actual equity investment in the partnership without being personally liable on the loans; and (3) conversion of ordinary income into capital gains.<sup>115</sup>

In an effort to eliminate some of the abuses caused by such devices, Congress enacted IRC § 465. This section limits the amount of loss an individual can claim for income tax purposes to "the aggregate amount . . . to which the taxpayer is at risk."<sup>116</sup> The limitation does not apply to corporations unless they are "small business" corporations or "closely held" corporations.<sup>117</sup> The taxpayer's amount at risk includes contributions of cash (at the time made) and income less deductions which are not withdrawn,<sup>118</sup> plus the adjusted basis of contributed property less any nonrecourse encumbrances, and less the adjusted basis of any property withdrawn,<sup>119</sup> plus any excess depletion not deducted,<sup>120</sup> and, plus a share of joint venture liability to the extent personally liable.<sup>121</sup> The amount at risk does not include amounts borrowed from persons who have an interest in the activity, other than that of a creditor, and amounts borrowed from "related taxpayers" within the meaning of IRC § 267(b),<sup>122</sup> or any amounts protected against loss through nonrecourse financing, guarantees, stop loss agreements, etc.,<sup>123</sup> and a taxpayer's amount at risk cannot be reduced below zero.<sup>124</sup>

The intent of the "at risk" rules, to eliminate arrangements that insulate taxpayers from "economic loss,"<sup>125</sup> has probably reduced the number of tax-sheltered financing arrangements available to speculative drillers. But, in doing so, they also reduced the general effectiveness of attracting nonindustry investment to oil and gas joint ventures in need of funding. In arriving at its deci-

115. *Joint Comm. on Internal Revenue Taxation, Tax Shelters: Oil and Gas Drilling Funds*, 94th Cong., 1st Sess., 1 (Comm. Print 1975).

116. I.R.C. § 465(a); Prop. Reg. § 1.465-1(d).

117. I.R.C. § 465(a); Prop. Reg. § 1.465-1(d).

118. I.R.C. § 465(b)(1)(A); Prop. Reg. § 1.465-22.

119. I.R.C. § 465(b)(1)(A); Prop. Reg. § 1.465-23.

120. Prop. Reg. § 1.465-45(d).

121. I.R.C. § 465(b)(2); Prop. Reg. § 1.465-24.

122. I.R.C. § 465(b)(3); Prop. Reg. § 1.465-8.

123. I.R.C. § 465(b)(4); Prop. Reg. § 1.465-6.

124. I.R.C. § 465(e); Prop. Reg. § 1.465-3.

125. *Senate Comm. on Finance, Report on the Tax Reform Act of 1976*, S. REP. NO. 938, 94th Cong., 2d Sess. 1 (1976), reprinted in 1976-3 C.B. 57, 87.

sion to implement the rules, Congress balanced the small independent driller's need for nonindustry financing against increasing intra-industry profits which could be used to finance the country's need for new wells, and came down on the side of intra-industry financing.<sup>126</sup> This approach tends to favor the larger driller-producer over the smaller independent driller, who has less access to funds than its large corporate or multicorporate rival. Thus, under present law, joint ventures in need of financing for exploration and development will encounter greater difficulty in locating it because of the greater restrictions imposed.

*Effect of a tribe's federal nontaxable status  
on problems encountered employing a traditional  
joint venture structure*

The "substantial economic effect" test in IRC § 704(b)(2) and the limitation on deductions to the "amount at risk" in IRC § 465 were designed and incorporated into the Code to restrict specific activities or transactions commonly found in oil and gas joint venture or partnership arrangements. In addition to these provisions, the Tax Reform Act of 1976 and the Revenue Act of 1978 enacted further provisions that restricted oil and gas joint venture or partnership transactions: IRC § 57(a)(11) added "intangible drilling costs" to the list of tax preference items subject to the "minimum tax" imposed by IRC § 56(a), unless tax liability would be greater by application of the "alternative minimum tax" under IRC § 55<sup>127</sup> and IRC § 1254, which provided for the "recapture" of intangible drilling costs as ordinary income upon the disposition of the oil and gas property.<sup>128</sup> These provisions, when combined with earlier restrictive provisions, e.g., the almost total elimination of percentage depletion under IRC § 613A, have reduced the incentive to employ joint ventures as the vehicle for the development of oil and gas resources, especially in light of the exclusion of corporations from the application of most of the provisions. In such a climate, a joint development program between a tribe and a nontribal participant would encounter con-

126. See note 115, *supra*, at 7.

127. The inclusion of intangible drilling costs as items of tax preference was designed as a deterrent to the current deduction as items of expense, as allowed under I.R.C. § 263(c). The provisions do not apply to corporations. I.R.C. § 57(a).

128. The recapture of intangible drilling costs was designed to limit the conversion of ordinary income into capital gain. The provision applies to all taxpayers. Income Tax Reg. § 1.1245-6.

siderable difficulty in creating a favorable federal income tax environment for the nontribal participant.

In the context of a traditional joint venture structure the federal nontaxable status of a tribe does not appear to provide any aid to the nontribal participant. For instance, some special allocations under the Code cannot be made by a tribe. Because a tribe exists as a nontaxable entity it does not have many of the attributes of a taxable entity that could be allocated to a nontribal participant, i.e., the tribe has no deductions or credits that could be allocated because such items only exist under the Code.<sup>129</sup> The tribe could allocate income or profit from a joint venture activity, but an allocation or shift of those items would not further the joint development goals of either party.<sup>130</sup> The only item a tribe could allocate would be an "economic loss" suffered by the tribe within the joint venture. Under the *Orrisch* line of cases and rulings, such special allocation would require the nontribal participant to bear the entire economic burden (cost) of the allocation by reducing its capital account and its share of liquidation proceeds. This form of special allocation is not uncommon in joint venture agreements, although it is usually accompanied by a provision that would allow the nontribal participant to recoup such losses in subsequent years,<sup>131</sup> thus allowing the participant to enjoy the advantage of currently deductible losses (to the extent allowed by the amount at risk). Nevertheless, because the tribe has no "paper" deductions or credits it could allocate (depreciation, depletion, or investment credit) and could only shift the burden of its economic losses, its nontaxable status does not appear useful as a means of encouraging nontribal participants and investors to enter into traditional joint venture based programs with the tribe.

The result does not appear different when applied to any other provisions of the Code, e.g., "at risk" provisions of IRC § 465. Because the Code, as recently amended, has centered its attention on restricting the taxable activities of the individual, it has created

129. *Cf. Snell v. Commissioner*, 10 B.T.A. 1081 (1928) (individual Indian wishing to offset taxable income from other sources was denied a deduction for depletion because of the tax-exempt status of the depletable property; the purpose for allowing deductions does not exist where the party is not subject to federal income taxation).

130. See text preceding and following note 24 *supra*.

131. See 2 WILLIS, PARTNERSHIP TAXATION 322-24 app. (2d ed. 1976) (Alternative Provision: Special Allocation of Net Loss if a Partner is Guaranteed against Partnership Losses in Excess of His Capital Investment).

a taxable burden that a tribe cannot readily influence. That is, the income tax burden of the nontribal participant is dependent upon its own individualized fact situation (e.g., whether it is a corporation, or the amount it has at risk, etc.) which exists independent of the tribe and its nontaxable status. Thus, in a traditional joint venture structure, the tribe's federal nontaxable status could do little to accomplish the beneficial effects sought by a joint program for the development of tribal oil and gas. This does not foreclose the possible use of a joint development type program for development of resources, but it does mean that tribes should look at other alternatives beyond the traditional joint venture approach.

*An Alternative: The Use of Packaged  
Oil and Gas Development projects*

For a tribe seeking an alternative to the lease-only system of the federal government, the alternatives it could employ are limited.<sup>132</sup> The traditional joint venture-partnership approach offers an opportunity for increased flexibility, control, and income for a tribe, but it provides little incentive to the oil and gas industry for participation in such an approach. Thus, a tribe should attempt to structure an alternative that would work toward the benefits embodied in a joint development program,<sup>133</sup> but which would be less restricted by the effects of the Internal Revenue Code.

This alternative could exist in the form of a tribal program for self-development which would employ the lease of prepackaged oil and gas development projects to participants within the oil and gas industry. Under such a program, the "package" offered for lease would have two components: (1) a lease of a fractional interest in tribal oil and gas, and (2) the sale-leaseback of equipment and technology required to develop reservation oil and gas. The inclusion of the oil and gas lease in the package would provide the lessee with a depletable economic interest in the oil and gas in place to the extent of the fractional interest of the lease. The balance of the production income would flow to the tribe based upon the fractional interest not granted in the lease. The lease would also provide for bonus, royalty, delay rental, etc., payments to the tribe, although such items could be varied,

132. See note 89, *supra*.

133. See text preceding and following note 24 *supra*.

negotiated, or virtually eliminated, according to the requirements of the project.

The second component, the sale-leaseback,<sup>134</sup> would involve two separate but integrated transactions. In the first transaction, the tribe would purchase the equipment and other assets involved in the exploration, drilling, and production of oil and gas, which would qualify for depreciation<sup>135</sup> and investment credit,<sup>136</sup> from the lessee-participant. The sale of this equipment, and its subsequent leaseback, must comply with the guideline provisions of Revenue Procedure 75-21.<sup>137</sup> Under these guidelines, the tribe must make and maintain an unconditional investment of at least 20% of the cost of the equipment purchased; and the ultimate lessee cannot furnish any part of the cost or provide any loans or loan guarantees to the tribe. The tribe may be able to finance the balance of the purchase price with nonrecourse notes repaid solely from rents received and secured solely by the equipment,<sup>138</sup> without jeopardizing depreciation or investment credit if the minimum investment is maintained and the notes are not secured by production.<sup>138</sup> The sale, in order not to be considered a "conditional sale,"<sup>140</sup> must clearly reflect the tribe's intent to hold the equipment after the term of the lease. Thus, particular attention must be paid to the structure of the lease.

134. See generally Walthall, 12-5th T.M. *Equipment Leasing: Comment, Leveraged Leasing: IRS Versus The Courts*, 12 CREIGHTON L. REV. 1133 (1979); Javaras & Nelson, *The New Leveraged Lease Guidelines*, 53 TAXES 388 (1975).

135. See, e.g., Rev. Proc. 77-10, 1977-1 C.B. 548, 552, at ¶ 13.1 & ¶ 13.2.

136. See I.R.C. § 48(a)(1).

137. 1975-1 C.B. 715, as supplemented by Rev. Proc. 75-29, 1975-1 C.B. 752. Section 201(a) of the Economic Recovery Tax Act of 1981, enacted Aug. 13, 1981, which added I.R.C. § 168(f)(8), and the Temporary Reg. § 5c.168(f)(8), T.D. 7791, 46 Fed. Reg. 51,907, amended and supplemented by T.D. 7795, 46 Fed. Reg. 56,148, created "safe harbor" rules that guarantee that a transaction will be treated as a lease for the purpose of allowing investment credit and capital cost recovery. Whether a tribe or its lessee-participant could make use of the "safe harbor" provisions may depend on whether the tribe would be considered a "corporation" for the purpose of the provisions. Applicable federal and state law should aid such a determination. See, e.g., Indian Reorganization Act of 1934, § 16, 25 U.S.C. § 476 (1977) (tribe as corporation under federal law), and 1978 N.M. STAT. ANN. § 53-9-1 (Pueblo as corporation under state law).

138. Although restricted to the facts presented in the letter ruling, the Service recognized the use of nonrecourse notes for the balance of the purchase price which were secured solely by the purchaser's interest and title in the equipment. Principal and interest were solely payable from rent. And, the lessee was obligated to obtain third party commitments for purchase of the notes from the lessor. See Doc. 7917033 (Jan. 24, 1979).

139. See Rev. Rul. 80-235, 1980-35 I.R.B. 7.

140. See Rev. Proc. 55-540, 1955-2 C.B. 39.



In the second transaction, the tribe would lease the equipment back to the lessee-participant. In doing so, the lease must comply with the guidelines provided in Revenue Procedure 55-540,<sup>141</sup> in order not to be classified as a "conditional sale": that is, no nominal lessee purchase option; lessee cannot acquire title after a certain number of payments; no portion of rent should appear as interest, etc. And, the lease must comply with the "leveraged lease" guidelines of Revenue Procedure 75-21 and Revenue Procedure 75-28,<sup>142</sup> by ensuring that the tribe's residual investment in the equipment at the end of the lease term will match the 20% minimum investment requirement amount, and that the lease contains no provision allowing the tribe to abandon the equipment or allowing the lessee an option to purchase. In addition, the lease must provide for rent at a profitable level for the tribe. The tribe also should recognize that the more liberal judicial requirements for determining the validity of a sale-leaseback transaction,<sup>143</sup> which previously have been applied primarily to real estate transactions, have also been applied to the leveraged leasing of equipment.<sup>144</sup> Notwithstanding such case law, the tribe should adhere as closely as possible to the requirements established by the Service.

Although some authority exists for the proposition that a seller-lessee can take depreciation and investment credit on a leveraged lease transaction,<sup>145</sup> the general rule is that an allowance for depreciation is dependent upon an economic investment or basis in the depreciable property.<sup>146</sup> This would mean that if a tribe is not allowed to take depreciation on the property it holds,<sup>147</sup> it could not pass on any investment credit<sup>148</sup> because the property would no longer fall under the definition of property subject to investment credit.<sup>149</sup> The lessee still would be able to claim depreciation or an annual deduction in lieu of depreciation

141. *Id.*

142. 1975-1C.B. 68 (requirements for taxpayer presented information).

143. *See, e.g.,* Frank Lyon Co. v. United States, 435 U.S. 561 (1978). *See also* Comment, *supra* note 134 at 1170.

144. *See* Davis v. Commissioner, 37 T.C.M. (P-H) 1441 (1978).

145. *E.g.,* Rev. Rul. 72-543, 1972-2 C.B. 87; Rev. Rul. 68-590, 1968-2 C.B. 66.

146. *See* I.R.C. § 167(a) & (g). *E.g.,* Narver v. Commissioner, 75 T.C.—No. 6, ¶ 75.6 (P-H) T.C. (Oct. 24, 1980).

147. *See* text at note 129, *supra*.

148. I.R.C. § 48(d)(1).

149. I.R.C. § 48(a)(1).

for any permanent capital improvements made on the leased property.<sup>150</sup>

If a tribe wished to retain depreciation and investment credit in order to increase the "value" of its development package, then it could take remedial action in the form of an equipment leasing joint venture. Such an enterprise should not be subject to the restrictions applicable to the development of trust property.<sup>151</sup> To minimize the adverse effects of the Code on the joint venture, the tribe should seek only corporations as participants so that investment credit could either be passed on to the lessee or retained by the corporate participant.<sup>152</sup> The tribe could provide, in the joint venture agreement, for tribal use of the equipment, and for subsequent purchase of used equipment for use in its own development.

The effect of a tribe's use of prepackaged development projects should be beneficial for all parties. The tribe would realize a greatly increased share of production and rental income, and it could control development of oil and gas within the reservation through careful project planning. The lessee-participant would realize depletable production and income, and would also have current deductions for rental payments on the equipment, as well as any pass-through of investment credit. The nontribal joint venture participant could have its distributional share of profit, loss, depreciation, interest expense, and investment credit, if not passed on to the lessee.

### *Conclusion*

Although tribes may possess substantial oil or other resources within the reservation, they are not using such resources in their best interests until they take an active role in the development of those resources. In order to assume this role, tribes must be aware of the development alternatives available to them and what effect these alternatives would have on both the tribe and the oil and gas industry. This means that a tribe should include some form of tax planning in their selection of a development alternative.<sup>153</sup> Such planning is commonly employed in the oil and gas

150. Income Tax Reg. § 1.167(a)-4.

151. See note 89 *supra*.

152. I.R.C. § 46(e)(3).

153. When considering the tax aspects of a program, tribal planners should keep the following in mind concerning the structure of the program: "The building may not be

industry to gain the maximum benefit for the industry. Thus, if the tribes wish to realize maximum benefits they must also examine and exploit tax planning and any other approaches that will enhance their goals for reservation development.

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constructed entirely from the tax advantage, but, if the foundation and bricks have economic substance, the economic or financial inducement of the tax advantage can provide the mortar." *McLane v. Commissioner*, 46 T.C. 140, 145 (1966), *aff'd per curiam* 377 F.2d 557 (9th Cir. 1967), *cert. denied*, 389 U.S. 1038 (1968).