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Taxing Times in Native America

by Gabriel S. Galanda and Anthony S. Broadman

Just as general tax matters run throughout every facet of civil practice, in Washington, Indian tax issues permeate the law. From the family law attorney who must evaluate trust assets of a Native American spouse, to the business practitioner minimizing his clients’ tax exposure, to the public lawyer serving state or local government, Washington lawyers are often confronted with the abstruse world of Indian tax, due in no small part to the resurgence of tribal economies and related rise of a tribal middle class. The rumors of tax-free Native America have been greatly exaggerated. Ironically, for an ostensibly tax-free zone, Indian tribes and lands are rife with nuanced tax issues that both tribal clients and non-Indian entities interacting with them must confront.

The commonly held but mistaken belief that individual tribal members are exempt from federal income tax tells only the beginning of the story. Both tribal governments and non-tribal parties doing business in Indian Country must carefully navigate the pitfalls of Indian tax law, which can often hinge on subtle factor-based tests and sprawling inquiries into the character of a putative taxable event and its players. If they and their counsel are successful, significant federal, state, and local tax savings can flow from Indian reservation-based transactions.

Still, the jurisdictional complexity of Washington's sovereign domestic nations certainly adds a layer of intricacy to an already labyrinthine area of the law.

Indian Tax Ground Rules

The U.S. Constitution vests the federal government with authority over tribal "commerce." Art I, Sec. 8, Cl. 3. As a corollary of this authority, and in recognition of the inherent sovereignty retained by Indian tribal governments even after formation of the United States, Indian tribes and tribal members are exempt from state taxation within tribal territory. Period. In fact, federal courts applying this rule characterize it as "per se" tax exemption. Outside of Indian Country, tribes and individual members cannot be taxed when a treaty with the United States — "the supreme Law of the Land" — precludes such taxation. U.S. Const. Art. VI, Cl. 2.

Even some state or local attempts to tax non-Indians doing business within the boundaries of a reservation are preempted by federal law, which presents an opportunity for them to obtain a significantly larger yield on their investment in Indian Country than might be available off the reservation.

But Anglo-American law makes converse, equally bright-line rules about when taxes must be paid. In general, unless they are exercising treaty rights or are otherwise immune, Indians conducting business outside Indian Country are likely subject to taxes like B&O, public utility, and sales taxes. These issues arise constantly among clients starting or winding up businesses in Washington Indian Country.

These are the clear rules. As discussed below, the gray areas provide more fodder for disagreement among the Washington State Department of Revenue, county assessors, tribes, and non-tribal businesses
transacting in Indian Country. Like Indian law in general, often subtle, seemingly arbitrary facts dictate outcomes in tribal tax matters.

**Property Taxes on Tribal Governments**

As Chief Justice Marshall observed in 1819, "The power to tax involves the power to destroy." In exercise of this principle, the U.S. Supreme Court has repeatedly held that a state is without power to tax reservation trust lands, or permanent improvements thereto, unless Congress has made its intent to allow state taxation "unmistakably clear."

Oddly, unmistakable clarity has been found in the General Allotment Act of 1887 as to fee land currently owned by tribes. *County of Yakima v. Confederated Tribes and Bands of Yakima Nation*, 502 U.S. 251 (1992). Trust land itself, however, is unmistakably non-taxable.

**Governments Without Property Tax Bases**

Most governments that provide services to their constituents draw revenue from a wide tax base. Washington tribal governments provide substantial and costly services to their members and local communities, but often lack a meaningful source of tax revenue, most notably property taxes. As some tribal and state government leaders and legislators have recognized, one obvious solution is to expand the "essential government services" exemption to protect tribal commercial activity off-reservation like it protects noncommercial activity from property taxes off-reservation, as described below.

Another less dramatic solution lies in the sovereign power of tribes over their particular corners of Indian Country. It is hornbook Indian law that in Indian Country, tribes possess regulatory authority over nonmembers who have entered into consensual commercial relationships with tribal government or business. This regulatory power extends — at least — to taxing authority, and likely far beyond. As tribes look for ways to provide much-needed social services and governmental functions to their memberships, taxes on businesses operating within their jurisdiction may provide the answer — including sales, hospitality, "sin," other excise, and B&O taxes. Balanced by a desire to encourage economic growth within the boundaries of reservations, tribes can take advantage via taxation of the non-tribal businesses discovering emerging post-gaming Indian Country markets.

Lawyers representing businesses subject to a tribe's taxing authority must advise their clients regarding this taxing power of the "third sovereign." While nobody enjoys paying taxes, often efficient tribal regulatory structures — for example, obtaining a permit in days rather than months or years — can offset the novel costs associated with doing business on Indian lands.

**Tribes and Members: Sovereignty and Taxpayers**

The income of tribal governments is exempt from federal taxation. Income tax statutes do not tax Indian tribal governments. Income earned by the tribe is not subject to tax, regardless of whether the business activity is inside or outside of Indian-owned lands. The income of federally chartered tribal corporations are also not subject to federal taxation, regardless of where such corporation earns income because, it has been determined, they have the same tax status as the tribe. The IRS has taken the position that a corporation organized by an Indian tribe under state law is subject to federal income tax regardless of the location of the activities that generate the income. The revenue of tribally owned corporations "integral"
to the tribal government and organized under tribal law are thought to be exempt from federal income tax.

In general, individual tribal members pay federal income taxes even if the income was otherwise tax-immune when first received by the tribe. However, income earned by tribal members from the exercise of treaty fishing rights, derived directly from land held in trust by the United States, or distributed per capita from a Court of Federal Claims judgment is not subject to taxation. Income is derived directly from land if it is generated principally from the use of land and resources; such use includes logging, mining, farming, or ranching.

**Taxes and Tribal Governmental Gaming**

The most misunderstood component of Indian tax law may be in the tribal governmental gaming arena. According to the Indian Gaming Regulatory Act of 1988, states per se cannot tax tribal governmental gaming activity. The IRS, however, taxes distributions of gaming revenue to individual tribal members; in fact, the federal law on Indian gaming requires tribal governments to notify their members that such distributions are taxable. In other words, if tribes reinvest gaming money into governmental functions, the IRS sees no tax dollars. But if tribal government distributes that money on a per capita basis to their members, each member enjoys taxable income according to the IRS, which in turn requires tribes to follow withholding and reporting requirements.

**More on Individual Indian Taxpayers**

When a state attempts to levy a tax directly on a tribal member inside Indian Country, courts employ a "categorical" approach: absent federal law to the contrary, the state cannot tax reservation lands and reservation Indians. For instance, taxes on Indian-owned personal property and Indian income earned on a reservation have both been struck down by the U.S. Supreme Court. That said, courts have held that tribal members who reside outside of a reservation are subject to state taxes on income, regardless of whether the income was derived from within an Indian reservation.

In addition, while states may not tax trust or allotment lands, and may not apply an excise tax to the sale of any land within an Indian reservation, states can tax reservation real property owned in fee by an individual Indian or non-Indian.

**State Sales Tax: From Tobacco to Reservation Economies**

Sales to Indians in Indian Country are exempt from Washington retail sales taxes. To constitute a sale in Indian Country, the State Department of Revenue requires that personal property be delivered to a tribal member or tribe in Indian Country or the sale must "take place," i.e., in a store, in Indian Country. WAC 458-20-192(5)(a)(i). Retail sales taxes are not imposed on services performed for an Indian or a tribe in Indian Country. As long as tangible personal property is acquired in Indian Country by an Indian or the tribe for at least partial use in Indian Country, use tax is also inapplicable.

In general, non-Indians must pay retail sales tax on sales on reservations. This usually includes sales on cigarettes. However, difficulty in the enforcement of such taxes has caused Washington's tribal and state governments to enter into agreements that often allow tribes to collect taxes rather than the state, as discussed below.
The exception to the general rule regarding sales taxes preempts taxes on even non-Indians in some situations. In some cases, state sales and use taxes are preempted where tribal and federal interests in the object of taxation outweigh the state's interest in taxation. This analysis is extremely fact-sensitive, and often hinges on the amount of value the tribe has added to a particular event or object. The Department of Revenue rules on tax preemption on a case-by-case basis, per agency rule.

**Tribal-State Tax Agreements**

Often arising in the tobacco and fuel sales tax context, tax agreements or "compacts" provide tribal governments with the ability to collect taxes in disputed jurisdictional situations. They allow the state to ensure that taxes are collected in tribal territory because, according to the U.S. Supreme Court, Washington lacks any meaningful ability to enforce state taxes on tribal lands or enforce them against Indian governments. *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134, 162 (1980); *Oklahoma Tax Comm'n v. Potawatomi Tribe*, 498 U.S. 505, 514 (1991). Under a tribal/state compact regime, if the state of Washington contends that it has the right to tax non-members on the sales of tobacco on a specific reservation, and the tribe on that reservation disagrees, the parties may agree that the tribe can collect taxes on such sales, as long as they are set at a certain level to prevent substantial price disparity. In doing so, the state focuses on the benefit that comes with certainty of taxed sales, closer pricing among tribal and non-tribal sellers, and social goals like smoking cessation, rather than the expense and risk of litigation. The tribe remains focused on using tobacco and fuel tax proceeds to fund essential governmental services and programs for their members and non-Indian neighbors.

**State B&O Taxes in Indian Country**

Washington's particular business revenue tax is limited by function of state and federal law. In general, income from sales made and services provided in Indian Country to tribes or Indians is not subject to B&O taxes. But taxpayers are responsible for maintaining suitable records to prove such exemption. For purposes of professionals like accountants or lawyers, services are performed substantially outside of Indian Country if 25 percent or more of the time taken to perform the service occurs outside of Indian Country.

**Indian Tax Burdens and Opportunities**

Although tribes do not pay federal taxes on income, according to the IRS, they are subject to federal tax laws. PLR 200420028. Courts generally support the IRS's position that Indian tribes are generally taxable entities with respect to federal taxes other than income tax. For instance, tribes have been subjected to FICA and FUTA. *Matter of Cabazon Indian Casino*, 57 B.R. 398, 402 (9th Cir. BAP 1986). Tribes also generally have to comply with reporting and withholding requirements for payments, such as those to employees. Rev. Rul. 59-354.

But for entrepreneurs and the lawyers who represent them, the federal tax structure also offers opportunity to businesses operating in Indian Country. Certain business property on Indian reservations is entitled to accelerated depreciation; the IRS sets out depreciation deduction recovery periods. The standards are relatively low except that such property cannot be for purposes of conducting gaming.
Certain infrastructure property is eligible for accelerated depreciation even if it is located outside Indian Country.

Employers in Indian Country can also enjoy tax credits based on wages paid to qualified employees who are enrolled tribal members or their spouses, who work on and live on or near the reservation. The IRS also provides tax incentives to businesses who locate within Empowerment Zones, for which reservations may be nominated, and Renewal Communities.

**Conclusion**

Ten years ago, researchers at the Evergreen State College opined that Washington tribal governments were contributing an estimated $140 million annually to the state and local tax structure. Today the numbers are likely far greater, due in part to the diversification of tribal economies and the rapid expansion of tribal business beyond gaming and tobacco. Just as you are aware of the state, local, and federal tax issues affecting your corner of Washington legal practice, take notice of the tax issues affecting the 29 other sovereigns in Washington state, and the individuals and businesses that transact with them.

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