TAX ISSUES IN INDIAN COUNTRY: A GUIDE FOR PRACTITIONERS

BY MARK J. COWAN

Layers of complexity are involved with the federal and state tax laws governing Indian tribes and tribal members and the federal, state, and tribal tax issues affecting non-Indian businesses operating on Indian reservations. Recently extended federal tax incentives to do business in Indian country and a new excise tax on tax shelter participation also must be taken into account.

MARK J. COWAN, CPA, is an assistant professor of accountancy at Boise State University. He also is an attorney, and has previously written for professional publications.

As American Indian[1] tribes continue to expand their commercial operations and develop their reservation economies, a greater number of non-Indian enterprises will be doing business with Indian tribes or operating on Indian reservations. Practitioners advising such businesses must, therefore, understand the unique interaction of federal, state, and tribal tax rules that apply in Indian country.[2]

THE LEGAL STATUS OF INDIAN TRIBES

Much of the tax complexity in Indian country results from the unique legal status of Indian tribes. The relationship between the tribes and the federal government is a special one, "marked by peculiar and cardinal distinctions which exist no where else."[3] Tribes retain inherent sovereignty, which existed prior to the arrival of Europeans in what is now the U.S.[4] Nevertheless, this sovereignty is subject to the control of the federal government.[5]

The Supreme Court has interpreted the Indian Commerce Clause of the Constitution, under which Congress has the power to "regulate Commerce ... with the Indian Tribes,"[6] as vesting exclusive power over the Indian tribes in the federal government.[7] State governments, therefore, may exercise jurisdiction over Indian tribes only to the extent provided by Congress. Tribes are thus sub-federal governments with a certain degree of sovereignty, but are not generally treated as states or as foreign nations under the law.[8] Accordingly, the familiar multi-jurisdictional tax rules that apply in the international and multistate tax contexts do not apply in Indian country.

Indians are not, as commonly thought, one homogenous group. Each individual tribe has its own history, culture, and economic status. There are currently 561 distinct Indian tribal governments that have been formally recognized by the federal government.[9] The tax rules discussed below apply only to tribal governments that have achieved federal recognition.[10]

Business Ventures of Indian Tribes

Current federal Indian policy encourages tribal self-government and economic development.[11] Some tribes have embraced this policy by setting up tribal business ventures to provide employment for tribal members and to generate revenue for governmental activities.

The most obvious example of tribal business activity is the operation of casinos. These range from large, "Las Vegas" style casinos in Connecticut[12] to much smaller establishments run by tribes in more remote areas.[13] Tribes engage in many commercial activities beyond gambling, however, including hotels, timber operations, restaurants, manufacturing plants, industrial parks, gas stations, smoke shops, and even professional sports franchises.[14] Some tribes have become low-cost locations for outsourcing of corporate functions,[15] or even venues for unpopular industries, such as cement factories.[16]

In addition, Indian tribes control approximately 56 million acres of land.[17] Minerals and other valuable natural resources have been discovered on some of this land, and Indian tribes have had to contract with outside professionals to tap into such wealth.[18]

Business deals with tribes are becoming more high profile. In December of

2006, for example, the Seminole Tribe of Florida agreed to purchase the Hard Rock Cafe and casino businesses from Britain's Rank Group for $965 million.[19]

Indian Gaming

The most lucrative business associated with Indian tribes is gaming. Federal law, embodied in the Indian Gaming Regulatory Act of 1988 (IGRA),[20] governs Indian gaming. Congress enacted IGRA in response to a 1987 U.S. Supreme Court decision that held California could not prohibit or regulate gaming occurring on Indian reservations within its borders.[21] IGRA gives states, tribes, and the federal government roles in regulating Indian gaming activities. Federal regulation is overseen by the National Indian Gaming Commission, established in the legislation.[22] IGRA divides Indian gaming into three classes, each with a different regulatory regime, as shown in Exhibit 1.

Class III games are the most lucrative, the ones the tribes most desire to conduct, and the ones the states most desire to prohibit, contain, or regulate. For this reason, the Class III games are the most heavily regulated, and require the state to agree to such games via a Tribal-State compact.[23] IGRA requires states to negotiate gaming compacts with tribes in good faith.[24] Class III games, however, cannot be conducted on Indian reservations located in states that prohibit all gaming for all purposes.[25]

IGRA specifically regulates how the tribe may spend the net revenues from Class II and Class III games.[26] Such net revenues may be used only:

- To fund tribal government operations or programs.
- To provide for the general welfare of the Indian tribe and its members.
- To promote tribal economic development.
- To donate to charitable organizations.
- To help fund operations of local government agencies.

The tribe is allowed to develop a formal plan to fund the above activities. If such a plan is approved by the Secretary of the Interior, the tribe may distribute any excess Class II and Class III income to tribal members per capita.[27]

IGRA contains some specific provisions that are germane to both federal and state taxation in Indian country. These issues are discussed later in this article.

NOTES

1 This article uses "Indian" (as opposed to "Native American") because that is the term normally used in the law, including the Internal Revenue Code (Section 45A, for example, is entitled "Indian Employment Credit").

2 The specific territory that is considered "Indian country" under the law is not always clear and may vary depending on the context. There may be circumstances where there is a threshold issue as to whether the taxpayer is actually operating within Indian country. In order to focus on the relevant tax issues, this possibility is ignored for purposes of this article. The boundaries of Indian country are assumed to be clear and the terms "Indian country" and "reservation" are used interchangeably. For more on the definition of Indian country, see *Cohen's Handbook of Federal Indian Law* (2005), § 3.04.

For a more policy-oriented discussion of the rules summarized in this article, see, e.g., Cowan, "Double Taxation in Indian Country: Unpacking the Problem and Analyzing the Role of the Federal Government in Protecting Tribal Governmental Revenues," 2 Pitt. Tax Rev. 93 (2005) (hereafter "Double Taxation") (discussing the problem of overlapping state and tribal tax jurisdiction in Indian county and reviewing possible solutions to the problem); Cowan, "Leaving Money on the Table(s): An Examination of Federal Income Tax Policy towards Indian Tribes," 6 Fla. Tax Rev. 345 (2004) (hereafter "Federal Income Tax Policy") (discussing the federal income tax treatment of Indian tribes and comparing such treatment to the federal income taxation of state governments).

3 Cherokee Nation v. Georgia, 30 U.S. 1 (1831).

4 Canby, *American Indian Law*, Third Ed. (West Publishing, 1998), page 68.

5 *Id.*, pages 86-87.

6 Article I, section 8, clause 3.

7 See Cherokee Nation, *supra* note 3.

8 *Id.*

9 See Bureau of Indian Affairs, Department of the Interior, www.doi.gov/bureau-indian-affairs.html.

10 For a discussion of the process of obtaining federal recognition as an Indian tribe, see *Cohen's Handbook, supra* note 2, § 3.02[3].

11 See, e.g., Canby, *supra* note 4, pages 29-32; *Cohen's Handbook, supra* note 2, § 21.01; see also California v. Cabazon Band of Mission Indians, 480 U.S. 202 (1987) (noting the federal government's "'overriding goal' of encouraging tribal self-sufficiency and economic development").

12 Such as Mohegan Sun (operated by the Mohegan tribe; see www.mohegansun.com/) and Foxwoods (operated by the Mashantucket Pequot tribe; see www.foxwoods.com/).

13 See, e.g., Useem, "The Big Gamble," Fortune, 10/2/00, page 222 (describing the modest business generated by the Spokane Indians' casino in Washington state).

14 See, e.g., Ansson and Oravetz, "Tribal Economic Development: What Challenges Lie Ahead for Tribal Nations as They Continue to Strive for Economic Diversity?," 11 Kan. J.L. & Pub. Policy 441 (2002) (listing typical tribal business ventures); Tebo, "Betting on Their Future," ABA J., May 2006, page 33 (discussing the legal issues surrounding the Tulalip Tribe's new shopping mall in Washington state); www.wnba.com/sun/ (website of the Women's National Basketball Association team Connecticut Sun, acquired by the Mohegan tribe in 2003).

15 See, e.g., McGregor, "The Other Indian Outsourcer: Accenture and the Umatilla Tribes' Bold Plan," Business Week, 11/6/06, page 40 (using Indian reservations allows corporate America to save money while avoiding the negative publicity, and possible negative legal consequences, of moving jobs to foreign countries).

16 Carlton, "Indian Tribe's Future Set in Cement," Wall St. J., 6/16/05, page B1.

17 *Cohen's Handbook, supra* note 2, § 21.01.

18 *Id.*; Alexander, "The Collision of Tribal Natural Resource Development and State Taxation: An Economic Analysis," 27 N.M. L. Rev. 387 (1997).

19 De la Merced, "Florida's Seminole Tribe Buys Hard Rock Cafes and Casinos," New York Times, 12/8/06, page C3.

20 Codified at 25 U.S.C. sections 2701-2721.

21 California v. Cabazon Band of Mission Indians, *supra* note 11. As noted in the text, states have power over Indian tribes only to the extent the federal government has granted them such power. While the federal government has granted states broad criminal jurisdiction in Indian country, it has not similarly granted the states civil/regulatory jurisdiction. *Id.* Because California did not prohibit all gaming activities (for example, gambling was allowed at certain charitable events and the state itself operated a lottery), the U.S. Supreme Court determined California *regulated* gaming rather than *prohibited* it. The Court held that California, in seeking to regulate gambling in Indian country, was attempting to exercise its civil/regulatory jurisdiction rather than its criminal jurisdiction, and thus exceeded its authority.

22 25 U.S.C. section 2704.

23 25 U.S.C. section 2710(d)(1).

24 25 U.S.C. section 2710(d)(3).

25 25 U.S.C. section 2710(d)(1)(B). If the state permits any gaming by "any person, organization, or entity" for "any purpose," however, it must negotiate with the tribes over Class III games. *Id.* Thus, if a state allows gaming for limited purposes, such as for "charity nights," tribes located within the state can negotiate compacts to allow Class III gaming on the Indian reservations.

26 25 U.S.C. section 2710(b)(2)(B). This provision applies specifically to Class II gaming, but 25 U.S.C. section 2710(d)(1)(A)(ii) applies the rules in section 2710(b)(2)(B) to Class III gaming as well.

27 25 U.S.C. section 2710(b)(3).

TAX TREATMENT OF TRIBES AND MEMBERS

To properly advise non-Indian clients negotiating business deals with Indian tribes or tribal members, practitioners should have a working knowledge of how tribes and their members are taxed. This knowledge will allow the non-Indian client to better understand the tribe's or tribal member's economic position.

Federal Income Tax Treatment of Indian Tribal Governments

Under long-standing IRS policy, Indian tribes are generally not subject to the federal income tax. Indian tribes are, in general, treated neither as state governments nor as nonprofit entities for federal income tax purposes. Rather, the IRS views the tribes as simply being outside the scope of the Internal Revenue Code, and thus not subject to the federal income tax. The IRS established this policy in a series of Revenue Rulings.

Key Revenue Rulings. In Rev. Rul. 67-284, 1967-2 CB 55, the Service simply stated that the "tribe is not a taxable entity." In Rev. Rul. 81-295, 1981-2 CB 15, the IRS stated that not only was the tribe a nontaxable entity but that any activities it conducted through a federally chartered Indian corporation would be exempt from federal income tax as well.

In Rev. Rul. 94-16, 1994-1 CB 19, the IRS made it clear that Indian tribes are not subject to the federal income tax on any of their activities whether conducted on or off the reservation. Rev. Rul. 94-16 also stated, however, that tribal activities conducted through a state-chartered corporation would be subject to the federal income tax. There is no detailed analysis explaining these conclusions.

The federal tax exemption embodied in these Rulings is based on long-standing IRS policy rather than constitutional mandate. Thus, Congress appears free to tax the tribes should it decide to do so.[28] In fact, on two occasions in the 1990s, Congress responded to the substantial casino profits earned by a couple of high-profile tribes by proposing to tax the Class II and Class III gaming profits of Indian tribes under the unrelated business income tax regime.[29] These proposals were never enacted. Should Indian tribes continue to be successful with casinos and other business ventures, however, Congress may well revisit the issue of taxing the Indian tribes.

■ **EXHIBIT 1**
IGRA Gaming Classes

	Description	Regulation
Class I	Traditional or ceremonial tribal games[1]	Games may be conducted without state or federal approval; regulated by the tribe only[2]
Class II	Bingo and related games; certain card games[3]	Games may be conducted under a tribal ordinance with federal approval via the National Indian Gaming Commission if the state allows gaming in any form[4]
Class III	All other games, including most casino games such as blackjack, craps, and slot machines[5]	Games may only be conducted with the consent of the state in which the tribe is located under a Tribal-State Compact approved by the Secretary of the Interior[6]

1 25 U.S.C. section 2703(6).
2 25 U.S.C. section 2710(a).
3 25 U.S.C. section 2703(7).
4 25 U.S.C. section 2710(b).
5 25 U.S.C. section 2703(8).
6 25 U.S.C. section 2710(d)(1).

IGRA tax provisions. As noted previously, tribal gaming activities are regulated by IGRA. IGRA explicitly states that per-capita distributions of Class II and Class III gaming profits to individual tribal members are taxable[30] and subject to withholding.[31] Upon payment, the tribe is required to notify the tribal members that the per-capita distributions are taxable.[32] Thus, while the tribe pays no tax on the casino income, the income is still taxed when distributed to the individual members.

Section 7871. The Code itself speaks to the taxation of Indian tribes in only one place. Section 7871 treats tribes as states for various purposes of the Code.[33] Specifically, Section 7871(a)(1) specifies that Indian tribal governments will be treated as states such that contributions to Indian tribal governments will be deductible for income, estate, and gift tax purposes. Section 7871(a)(2) applies state exemptions for certain excise taxes[34] to Indian tribal governments, but only if the tribe is acting in an essential governmental function.[35] Section 7871(a)(3) allows taxes paid to Indian tribes to be deductible in the same manner as taxes paid to states under

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28 For an analysis of the constitutional issues at stake, see Cowan, "Federal Income Tax Policy," *supra* note 2, pages 381-88. While Indian tribes have inherent sovereignty, such sovereignty is subject to limitation by Congress. See Canby, *supra* note 4, pages 86-87.

29 See Lightman, "Indian Casino Taxes Rejected," Hartford Courant, 6/13/97, page A1. For a detailed discussion of the proposed tax and the arguments surrounding it, see Cowan, "Federal Income Tax Policy," *supra* note 2, pages 383-88.

30 25 U.S.C. section 2710(b)(3)(D).

31 Section 3402(r).

32 25 U.S.C. section 2710(b)(3)(D).

33 Notably, Section 7871 does not treat tribes as states for purposes of the federal income tax. States are generally exempt from the federal income tax under the Service's longtime interpretation of Section 115. See GCM 14407, 1935-1 CB 103 (1/28/35). The federal income tax exemption for tribes derives not from Section 7871, but from the Revenue Rulings previously discussed. For more on the tax treatment of states, see Cowan, "Federal Income Tax Policy," *supra* note 2, pages 368-80.

Section 164. Section 7871(a)(4) allows tribes, like states, to issue tax-exempt bonds. Unlike states, however, tribes may issue tax-exempt bonds only to finance an essential governmental function.[36]

Section 7871(a)(5) indicates that any colleges or universities run by a tribe will be subject to the unrelated business income tax on any income generated from business activities that are regularly carried on and are unrelated to the institution's exempt mission. This puts the tax treatment of private colleges and universities, state colleges and universities, and tribal colleges and universities on an equal footing. This is, of course, a very narrow exception, but it is the one place in the Code that Indian tribes are explicitly subjected to the federal income tax.

The familiar multijurisdictional tax rules that apply in the international and multistate tax contexts do not apply in Indian country.

Section 7871(a)(6) makes state rules regarding accident and health plans and retirement plans applicable to the tribes. Finally, Section 7871(a)(7) applies the limitations on lobbying by tax-exempt organizations and the excise tax on lobbying by private foundations to lobbying activities directed towards Indian tribal governments.

Ambiguities. The unique status of Indian tribes in the federal income tax law creates ambiguities over how Indian tribes will be treated for various purposes of the Code. For example, in Rev. Rul. 2004-50, 2004-1 CB 977, the IRS ruled that an Indian tribal government was not eligible to be a shareholder in an S corporation under Section 1361 because it was neither an "individual" nor a Section 501(c)(3) organization for purposes of the Code. In Ltr. Rul. 200041023, the Service ruled that the merger of a state-chartered, tribal-owned corporation (generally taxable, as noted above) into a federally chartered corporation (generally not taxable, as noted above) was a taxable event.

Other federal taxes. Even though tribes are exempt from the federal income tax, they are still required to pay other federal taxes and comply with certain information reporting requirements. In Rev. Rul. 59-354, 1959-2 CB 24, the IRS ruled that tribes, as employers, are subject to FUTA and FICA.[37] Tribes also, in general, comply with federal tax withholding rules.[38]

The IRS has also ruled that tribes are subject to information reporting requirements. For example, in TAM 200420028, the IRS ruled that an Indian tribe was required to issue Forms 1099 to winners of a tribal powwow dance contest.

Indian tribes and tax shelters. The tax-free status of Indian tribes has made them, in the past, ideal tax-indifferent "accommodating parties" in certain tax-shelter-type transactions. Historically, Treasury would combat tribal involvement by promulgating Regulations to address specific transactions.

For example, tribes would sometimes be used to facilitate the sale of a business when the seller wanted to sell the stock of the corporation holding the business, while the buyer desired to purchase the assets of the business itself.[39] This situation would arise when the seller had a high basis in its stock and the buyer desired the depreciation deductions that would result from taking a stepped-up basis in the appreciated assets of the acquired business. The seller would sell stock to the tribe, which would liquidate the corporation and then sell the business's assets to the buyer. The tribe would receive a fee for its services. Treasury solved this problem by issuing Regulations requiring the liquidating corporation to recognize gain in such a situation, as if it had sold its assets immediately before its liquidation.[40]

In TIPRA, Congress responded more broadly to tribal involvement in tax shelters by enacting an excise tax on tax-exempt entities that are parties to tax shelter (listed) transactions.[41] An Indian tribal government is considered a "tax-exempt entity" for this purpose.[42] The tax is equal to the highest corporate tax rate times the greater of the entity's net income or 75% of the proceeds received by the entity in connection with the tax shelter transaction.[43] If the entity knew or had reason to know that it was a party

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34 These include the tax on special fuels, manufacturers' excise taxes, the communications excise tax, and the tax on the use of certain highway vehicles; see Sections 7871(a)(2)(A) through (D). Outside of the protections of Section 7871(a)(2), federal excise tax issues in Indian country can become complex and confusing. The Supreme Court, for example, had to navigate ambiguous statutes to rule in Chickasaw Nation v. U.S., 534 U.S. 84 (2001), that tribes are subject to the federal wagering and occupational taxes associated with certain casino games. Further discussion of excise taxes is beyond the scope of this article.

35 Section 7871(b).

36 Section 7871(c). This requirement means that tribes can use tax-exempt bonds only to finance projects that states would "customarily" engage in; see Section 7871(e). Tribes thus cannot be innovators in the use of tax-exempt financing. See generally Aprill, "Tribal Bonds: Indian Sovereignty and the Tax Legislative Process," 46 Admin. L. Rev. 333 (1994). Further discussion of tribal tax-exempt bonds is beyond the scope of this article.

37 Payments to tribal council members, however, are generally exempt. See Rev. Rul. 59-354, 1959-2 CB 24. There is some dispute as to whether the FICA statute technically applies to Indian tribes, but for the most part tribes are best advised to pay the tax. See *Cohen's Handbook, supra* note 4, § 8.02[2][c].

38 *Cohen's Handbook, supra* note 4, § 8.02[2][c].

39 See Glicklich and Leitner, "Loss Importation—Opportunities and Limitations," 1999 TNT 30-138.

40 Reg. 1.337(d)-4(a). The Regulation applies, with certain exceptions, when a taxable corporation transfers all of its assets (such as on liquidation) to a tax-exempt entity. A tribe is considered a tax-exempt entity for this narrow purpose; see Reg. 1.337(d)-4(c)(2)(iv).

41 Section 4965(a)(1). Per Section 4965(e), transactions that would generate the excise tax are defined in Section 6707A(c). That section in turn defines such transactions as those that the Treasury has identified as having tax-avoidance potential.

42 Section 4965(c)(3). As discussed previously, Indian tribes are *not* generally considered "tax-exempt entities" (e.g., Section 501(c)(3) organizations) for purposes of federal tax law.

43 Section 4965(b)(1)(A).

to a prohibited tax shelter, the excise tax is increased to the greater of 100% of the entity's taxable income or 75% of the proceeds received by the entity in connection with the tax shelter transaction.[44] An entity manager who approves of a transaction that she knows or has reason to know is a prohibited tax shelter will be subject to an excise tax of $20,000 per approval.[45]

IRS views the tribes as simply being outside the scope of the Internal Revenue Code, and thus not subject to the federal income tax.

A taxable party to a tax shelter transaction in which a tribe (or any other "tax-exempt entity") is involved must disclose to the tribe that the transaction is a prohibited tax shelter transaction.[46] Further, the tribe itself must disclose its participation in the prohibited transaction to the IRS, along with the identity of any other participants known to the tribe.[47] The tribe is subject to penalties if it fails to make the disclosure.[48] Given the high cost these provisions extract, they are likely to discourage tribes from entering into prohibited tax shelter transactions in the future.

Federal Taxation of Individual Indians

Contrary to popular belief, members of Indian tribes *are* subject to the federal income tax.[49] The Supreme Court made this clear in *Squire v. Capoeman*, 351 U.S. 1, 49 AFTR 178 (1956): "Indians are citizens and ... 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."

Despite this general rule of taxation, tribal members do enjoy certain special, narrow tax exemptions in certain circumstances. For example, income derived from "allotted lands" held in trust by the federal government on behalf of tribal members is exempt from the federal income tax.[50] This exemption is not in the Code but rather derives from the Supreme Court's interpretation in *Squire v. Capoeman* of the General Allotment Act, an 1887 law which provided that certain tribally held lands were to be allotted to individual tribal members but were to be held in trust for such members by the federal government.[51] The IRS, in Rev. Rul. 67-284, 1967-2 CB 55, set out a five-part test to determine whether income is covered by this exemption:

1. The land in question is held in trust by the U.S.

2. Such land is restricted and allotted and is held for an individual noncompetent Indian, and not for a tribe.

3. The income is "derived directly" from the land.

4. The statute, treaty, or other authority involved evinces congressional intent that the allotment be used as a means of protecting the Indian until such time as he becomes competent.

5. The authority in question contains language indicating clear congressional intent that the land, until conveyed in fee simple to the allottee, is not to be subject to taxation.

If one or more of these tests is not met, and if the income is not otherwise exempt by law, it is subject to federal income taxation. Rev. Rul. 67-284 also makes it clear that income earned from the reinvestment of income earned from the land will be taxable.[52]

Another exemption that some Indians enjoy comes from Section 7873, which provides that income earned by an Indian from fishing rights that have been recognized by a treaty is exempt from the federal income tax. This is a narrow exemption. The Tax Court, for example, has refused to extend it to cover cancellation of debt income realized by an Indian on the foreclosure of his fishing boat.[53]

Finally, individual Indians enjoy special tax exemptions under specific statutes, outside of the Code, for certain settlement payments received from the federal government. For example, certain settlement payments to Indians belonging to the Shoshone Tribe are exempt from tax.[54] These exemptions, which are too numerous to list here, are generally found in Title 25 of the U.S. Code, which deals with Indian affairs.[55]

State Taxation of Indian Tribes and Members

In discussing state tax jurisdiction on Indian reservations, it is important to distinguish between "members" and "nonmembers." An individual Indian is a member of a tribe if the individual is listed on the membership roll of the tribe controlling the reservation on which the individual resides or does business. All others, including non-In-

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44 Section 4965(b)(1)(B).

45 Section 4965(b)(2).

46 Section 6011(g).

47 Section 6033(a)(2).

48 Section 6652(c)(3).

49 In fact, the belief that there is an Indian exemption is so widespread that the IRS has listed the notification of Indians that they are exempt from tax (and related schemes) as one of the top tax scams for 2007. See IR-2007-37, 2/20/07, and Shop Talk, "Dirty Dozen, Part VI: IRS Identifies Five New Ways 'Scamsters' Go After Taxpayers," 106 JTAX 190 (March 2007).

50 Rev. Rul. 67-284, 1967-2 CB 55.

51 25 U.S.C. section 348. The General Allotment Act was designed to take lands out of tribal hands and put them into the hands of the individual tribal members. This reflected prevailing federal Indian policy in the late 19th century, i.e., to assimilate Indians into the general population. See *Canby, supra* note 4, pages 20-23. To protect the new Indian landowners from unscrupulous purchasers, however, the Act included trust provisions to prevent "sale, incumbrance, or taxation." As indicated previously, modern federal Indian policy supports the preservation and economic independence of the tribes. Although the restrictions on allotted land were due to expire within 25 years of the enactment of the General Allotment Act, the President and Congress extended the restrictions on many of the allotments. See *Cohen's Handbook, supra* note 2, § 16.03[4][b][ii]. As of 1999, there were still approximately 11 million acres of allotted land. *Id.*, § 16.03[4][a].

52 Beyond this, there are numerous issues as to whether income will be covered by this exemption. For further information on these issues, see Monsivais, "The Return of the White Buffalo: Taxation Issues Facing American Indian Tribes Conducting Gambling Enterprises on Tribal Lands," 20 Am. Indian L. Rev. 399 (1996), pages 403-07.

53 Warbus, 110 TC 279 (1998). For a detailed analysis and critique of this decision, see Jensen, "American Indian Law Meets the Internal Revenue Code: Warbus v. Commissioner," 74 N. Dak. L. Rev. 691 (1998).

54 25 U.S.C. section 589.

55 For a listing of the specific tribes and exemptions involved, see Maule, 501-2d T.M. (BNA, 2006), *Gross Income: Overview and Conceptual Aspects*, XII.A.3.a.

dians and members of other Indian tribes, are considered nonmembers. For example, an enrolled member of the Navajo tribe conducting business on the Navajo reservation would be considered a member. A member of the Sioux tribe, however, doing business on the Navajo reservation would be considered a nonmember. With respect to state or tribal tax matters, the Sioux Indian would be treated like any other non-Indian doing business on the Navajo reservation.[56]

Tribal activities conducted through a state-chartered corporation, however, would be subject to the federal income tax.

As the Supreme Court has made clear, Indian tribes and tribal members may not be subject to direct state taxation on activities taking place on the reservation.[57] In short, if the legal incidence of the state tax falls on the tribe or member and the taxed activity takes place on the reservation, it will not stand.[58] As discussed below, however, states generally may impose a tax on nonmembers doing business on the reservation, even if the economic burden of the tax is ultimately borne by the tribe or its members.

States may, absent any federal laws to the contrary, tax tribes and tribal members on their activities that are conducted off the reservation.[59] Thus, to the extent that tribal members stay on the reservation, they are not generally subject to state taxation.

State tax aspects of Indian gaming. As noted above, IGRA requires that states and tribes negotiate a compact before tribes are allowed to engage in Class III gaming activities. IGRA specifically says that states are not granted the authority to tax tribal gaming revenues. In fact, states are prohibited from making their negotiation of compacts contingent on the tribes' granting them taxing power over tribal businesses.[60]

Despite these provisions, states still may validly extract payments (not "taxes") from tribes either to help defray any additional regulatory costs the state may incur because of the gaming activity[61] or in exchange for an economic benefit that the state has conferred on the tribe.[62] The latter situation usually involves the state's granting the tribe an exclusive right to operate a certain game (e.g., slot machines) in the state in exchange for a share of the revenues from that game. Connecticut, for example, under its gaming compacts with the Mohegan and Mashantucket Pequot tribes, is entitled to 25% of the net monthly slot machine revenues at the casinos run by those tribes. The 25% payment was negotiated in exchange for granting the two tribes the exclusive right to operate slot machines in the state.[63] Through 2002, tribal payments to the state have totaled over $2.3 billion.[64] To date, seven states have entered into revenue-sharing agreements with tribes.[65]

In summary, Indian tribes are generally exempt from the federal income tax on all of their activities, whether commercial or governmental, and whether earned on or off the reservation. Tribes are taxed, however, if their colleges or universities generate unrelated business income or if the tribe operates its business ventures through a state-chartered corporation. Tribes may be subject to FICA, FUTA, and certain excise taxes. Further, tribes may be subject to a special excise tax if they engage in tax shelter activities. Individual Indians, in contrast, with some very narrow exceptions, are generally subject to the federal income tax. Indian tribes and tribal members are generally not subject to state taxes on activities occurring on the reserva-

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56 See, e.g., Washington v. Confederated Tribes of Colville Indian Reservation, 447 U.S. 134 (1980) (Indians from tribes other than the tribe governing the reservation "stand on the same footing as non-Indians resident on the reservation").

57 See, e.g., Okla. Tax Comm'n v. Chickasaw Nation, 515 U.S. 450 (1995) (striking down a state fuel excise tax assessed on fuel sold by tribally owned stores and stating that a state tax will not stand if the legal incidence is directly on the tribe or a tribal member operating entirely on the reservation); Montana v. Blackfeet Tribe of Indians, 471 U.S. 759 (1985) (striking down a state tax on royalties the Blackfeet tribe received from nonmember lessees of oil and gas properties on the reservation); Washington v. Confederated Tribes of Colville Indian Reservation, *supra* note 56 (striking down a state motor vehicle "privilege" tax assessed on tribal members); Bryan v. Itasca County, Minn., 426 U.S. 373 (1976) (striking down a state personal property tax on a mobile home owned by a tribal member because it was not explicitly authorized by federal law); Moe v. Confederated Salish and Kootenai Tribes of Flathead Reservation, 425 U.S. 463 (1976) (striking down state cigarette and motor vehicle taxes where the legal incidence of the tax fell on a tribal member); McClanahan v. State Tax Comm'n of Ariz., 411 U.S. 164 (1973) (ruling that Arizona may not impose its personal income tax on a tribal member working exclusively on the reservation). While tribal members can escape state taxation while working on the reservation, they may be subject to taxes that are imposed by the tribe. Tribal taxes are discussed later in this article.

58 The legal incidence of a tax is usually clear: it is the party named in the statute who is legally obligated to pay the tax to the state. States thus can effectively tax tribes and tribal members simply by crafting their statutes to impose their taxes on nonmembers doing business on the reservation rather than imposing the tax directly on the Indian tribe or tribal members. The nonmembers would then, in many cases, simply pass on the economic burden of the taxes to the tribe or tribal members. But see Coeur D'Alene Tribe of Idaho v. Hammond, 384 F.3d 674 (CA-9, 2004), which held that the legal incidence of Idaho's motor fuels tax was on tribally owned gas stations—and therefore prohibited—despite the Idaho legislature's recent attempt to amend the motor fuels tax statute to place the legal incidence on the nonmember fuel distributor.

59 See, e.g. Okla. Tax Comm'n v. Chickasaw Nation, *supra* note 57 (upholding a state income tax on tribal members who worked for an Indian tribe, but who lived off the reservation); Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973) (allowing New Mexico to impose a gross receipts tax on a tribal ski resort operated outside of the tribe's reservation).

60 25 U.S.C. section 2710(d)(4).

61 25 U.S.C. section 2710(d)(3)(C)(iii).

62 Zelio, "Tribal taxation, state," in Cordes et al., *The Encyclopedia of Taxation & Tax Policy* (2nd ed., 2005), page 450.

63 Green, "Slots Revenue Rises 5.4%," Hartford Courant, 11/16/02, page B5.

64 *Id.* In fiscal 2004-2005, Connecticut received nearly $418 million in revenue from the state's two Indian casinos. See Connecticut Division of Special Revenue, "At a Glance," www.das.state.ct.us/Digest/Digest_2005/Special%20Revenue,%20Division%20of.htm. In comparison, the state netted only $268.5 million from its lottery. *Id.*

65 Zelio, *supra* note 62.

tion, but can be taxed on activities that occur off the reservation.

FEDERAL TAXATION OF NONMEMBERS DOING BUSINESS IN INDIAN COUNTRY

Nonmembers doing business in Indian country generally are subject to the same federal taxes they normally pay when operating elsewhere within the U.S. The federal government, however, provides two tax incentives to invest in Indian country:

- A special employment tax credit.[66]
- Accelerated deprecation for property used on Indian reservations.[67]

The impact of these incentives should be considered when making investment decisions, as they offset some of the burdens of doing business in Indian country, such as the potential for joint tribal/state taxation (discussed below). These incentives were first enacted, on a temporary basis, as part of RRA '93 to encourage economic growth on Indian reservations.[68] The temporary incentives have been periodically renewed, and were most recently extended as part of the Tax Relief and Health Care Act of 2006.[69] As of this writing the incentives are due to expire on 12/31/07.[70] While the incentives are meant to benefit all Indian reservations, they are crafted to avoid benefiting businesses associated with Indian gaming operations.

Indian employment tax credit. Employers may claim, as part of their general business credit, a credit for certain wages and health insurance costs paid to "qualified employees."[71] To be qualified, the employee must be a member of an Indian tribe (or the spouse of a member), must perform substantially all of the services for the employer on an Indian reservation, must live on or near such reservation, must not earn annual wages from the employer in excess of $30,000[72] (indexed for inflation, the wage limit is now $40,000),[73] and must not work in gaming operations or in a building in which gaming activity is performed.[74] Further, the employee cannot be a 5% owner of the employer or otherwise be "related" to the employer.[75] Greater than 50% of the wages paid to the employee must be for services performed in the *trade or business* of the employer.[76]

The credit is equal to 20% of the excess of wages and health insurance costs paid (or incurred) to qualified employees in the current year over such amounts paid in 1993.[77] Thus, the credit is based on the incremental amounts paid over the 1993 base year. The aggregate amount of wages and health insurance costs that may be considered in this calculation for any one qualified employee, for both the current year and the 1993 base year, is $20,000.[78] Health insurance paid for via a salary reduction agreement will not count as "health insurance costs" for purposes of the credit.[79] The credit must be recaptured if the employer claims a credit for amounts paid to an employee and the employer terminates that employee within one year after the employee began work.[80]

While the tribe pays no tax on the casino income, the income is still taxed when distributed to the individual members.

The credit is calculated and claimed on Form 8845, Indian Employment Credit. The taxpayer must also complete Form 3800, General Business Credit, if claiming credits in addition to the Indian employment credit. The Indian employment credit, when combined with the taxpayer's other general business credits, is subject to the overall limitations that apply to all general business credits.[81] General business credits are limited, in general, to the excess of the taxpayer's net income tax over the greater of the taxpayer's tentative minimum tax for the year or 25% of the amount of taxpayer's regular tax liability that exceeds $25,000.[82] Any unused credit may be carried back one year and forward 20 years.[83] Any amount that the taxpayer claims as an Indian employment credit will reduce the taxpayer's deductions for wages and health insurance.[84]

Accelerated depreciation. "Qualified Indian reservation property" that is placed in service after 1993 but before the expiration of the statute (currently, 12/31/07) is eligible for faster deprecation than is typically allowed under the Modified Accelerated Cost Recovery System (MACRS).[85] This accelerated depreciation applies for both regular and alternative minimum tax purposes.[86] Exhibit 2 depicts the recovery period for qualified Indian reservation property.[87]

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66 Section 45A.

67 Section 168(j).

68 Many Indian reservations suffer from lack of infrastructure, such as paved roads, electricity, and telephone service. Kurman, "Indian Investment and Employment Tax Incentives: Building a New Highway to Indian Country for Private Sector Businesses and Jobs," 41 Fed. Bar News & J. 578 (1994), page 583. It was hoped that the employment tax credit and the accelerated deprecation incentives would encourage businesses to invest on Indian reservations despite these shortcomings. *Id.*

69 P.L. 109-432, 12/20/06, sections 111(a) (Indian employment credit) and 112(a) (accelerated depreciation).

70 Section 45A(f) (Indian employment credit); Section 168(j)(8) (accelerated depreciation).

71 Sections 45A(a) and (b).

72 Section 45A(c). The statute indicates that the employee must be a member of "an" Indian tribe and employed on "an" Indian reservation, thus implying that an employer could take a credit for wages paid to an employee who is the member of one tribe but works and lives on or near the reservation of a different tribe.

73 Instructions for Line 1, Form 8845, Indian Employment Credit (Rev. December 2006).

74 Section 45A(c)(5)(C).

75 Sections 45A(c)(5)(A) and (B). See Section 51(i)(1) for a list of relationships that will disqualify the employee.

76 Section 45A(c)(4).

77 Section 45A(a).

78 Section 45A(b)(3).

79 Section 45A(b)(2)(B).

80 Section 45A(d). The credit need not be recaptured if the employee leaves voluntarily, or is terminated because of a disability or for misconduct (as defined by the applicable state unemployment compensation law); see Section 45A(d)(3).

81 See Section 38.

82 Section 38(c)(1). See Sections 38(c)(2) through (5) for special rules that may alter this limitation.

83 Section 39(a).

84 Section 280C(a).

85 Section 168(j)(1).

86 Section 168(j)(3).

87 Section 168(j)(2). There is no special recovery period for 27.5 year property (residential real estate).

"Qualified Indian reservation property" is property of the type listed in Exhibit 2 that is used in the taxpayer's active trade or business within an Indian reservation, is not regularly located or used outside of the reservation, was not acquired from a related person (as defined in Section 465(b)(3)(C)), and is not used to conduct or house gaming operations.[88] In some instances, property located outside a reservation also may qualify for the accelerated recovery periods if it is "qualified infrastructure property."[89] This includes property such as roads, power lines, water systems, railroad spurs, communications facilities, or similar property that is located outside the reservation but is connected to qualified infrastructure property located within the reservation. The infrastructure property located outside the reservation must benefit the tribal infrastructure, be available to the general public, and must be placed in service in connection with the conduct of the taxpayer's active trade or business located within the reservation.[90]

■ EXHIBIT 2
Depreciation

Normal MACRS recovery period	Recovery period for qualified Indian reservation property
3 years	2 years
5 years	3 years
7 years	4 years
10 years	6 years
15 years	9 years
20 years	12 years
39 years (nonresidential real property)	22 years

TRIBAL TAXES

Clients doing business in Indian country may be subject to tribal taxes in addition to federal and state taxes. Tribal governments, like most sovereign entities, provide services to their members and outsiders and therefore must raise revenue. Tribes generally raise the needed revenue through business ventures (such as casinos) or via taxation. Tribes have the authority to impose taxes on both tribal members and generally on nonmembers visiting or doing business on the reservation.[91] Because of the poor conditions on many Indian reservations, tribes (like many state governments) design their tax systems so that the incidence of taxation falls primarily on non-Indians visiting or doing business on the reservation. The most common tribal taxes, therefore, are transactional taxes such as severance taxes, sales taxes, fuel taxes, hotel occupancy taxes, and beverage taxes.[92]

Many tribal tax codes are neither widely published nor available on the usual research services relied on by tax professionals. Therefore, practitioners with clients planning to transact business on a reservation should plan on checking with the tribal government directly for the terms of the applicable tribal tax laws.[93] The Navajo tax laws and the Mashantucket Pequot tax laws are reviewed below as examples of tribal tax systems.

Navajo taxes. Among tribal tax systems, the Navajo tax system is perhaps the most sophisticated. The Navajos are an example of a tribe that attempts to raise substantial dollar amounts via taxation. In fiscal 2003, the Navajo Nation collected approximately $70.6 million in taxes.[94] The Navajo taxes include:

- A 5% business activity tax on net gains from services performed on the reservation or net gains from the sale of goods produced, processed, or extracted on the Navajo reservation.[95]
- An 18¢ per gallon fuel excise tax.[96]
- An 8% hotel occupancy tax.[97]
- A possessory interest tax equal to 3% of the appraised value of certain rights to be on Navajo land (applies to oil and gas leases, coal leases, rights-of-way, and business site licenses granted by the Navajo tribal government).[98]
- A 3% sales tax.[99]
- A 4% severance tax on the value of oil and gas removed from Navajo territory.[100]
- A tobacco tax of 40¢ per pack of cigarettes sold on the reservation.[101]

Mashantucket Pequot taxes. In contrast, the Mashantucket Pequot tribe in Connecticut raises most of its govern-

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88 Section 168(j)(4)(A). Under a special rule, the rental, to others, of real estate located within an Indian reservation is treated as an active trade or business, and thus may qualify for the accelerated depreciation if all of the other requirements are met. See Section 168(j)(5).

89 Section 168(j)(4)(C).

90 *Id.*

91 See, e.g., Merrion v. Jicarilla Apache Tribe, 455 U.S. 130 (1982) (holding a tribe may impose, based on its inherent sovereign governmental powers, a severance tax on nonmember lessees extracting oil and gas from the reservation); Washington v. Confederated Tribes of Colville Indian Reservation, *supra* note 56 (upholding a tribal cigarette tax on nonmembers purchasing cigarettes on the reservation). But see Atkinson Trading Co., Inc. v. Shirley, 532 U.S. 645 (2001), where the Court held that the Navajo Nation was prohibited from imposing a hotel occupancy tax on nonmembers staying at a hotel located on fee land located within the reservation. The case was not concerned so much with the inherent rights of the tribe to tax as with the borders of the tribe's taxing jurisdiction. As noted above, a discussion of what constitutes "Indian country" is beyond the scope of this article; see note 2, *supra*.

92 For a summary of the history of tribal taxes, see Cowan, "Double Taxation," *supra* note 2, pages 102-04.

93 Practitioners also can check www.tribalresourcecenter.org/tribalcourts/codes/codesdirectory.asp for links to on-line tribal codes (including tax codes).

94 www.navajotax.org/new_page_7.htm.

95 Navajo Nation Code, title 24, sections 401-445. The Navajo tax statutes, regulations, and forms are available at www.navajotax.org.

96 *Id.*, sections 901-923.

97 *Id.*, sections 700-741.

98 *Id.*, sections 201-245.

99 *Id.*, sections 601-624.

100 *Id.*, sections 301-345.

101 *Id.*, sections 800-810. There also is a related tax on other tobacco products such as cigars and smokeless tobacco.

Practice Notes

Many tribal tax codes are neither widely published nor available on the usual research services relied on by tax professionals. Therefore, practitioners with clients planning to transact business on a reservation should plan on checking with the tribal government directly for the terms of the applicable tribal tax laws. Practitioners also can check www.tribalresourcecenter.org/tribalcourts/codes/codesdirectory.asp for links to on-line tribal codes (including tax codes).

mental revenue from its large and profitable Foxwoods Resort and Casino. Despite this steady stream of the funds, the Mashantucket Pequot tribe has a formal tax code included in its tribal laws, which includes:

- A 12% hotel occupancy tax.[102]
- A 6% food and beverage tax.[103]
- A 6% retail sales tax.[104]
- A 10% admissions tax (applied to the cost of admission to amusement, entertainment, or recreation facilities).[105]
- A $900 per year real estate home ownership tax.[106]

With the exception of the real estate home ownership tax, these taxes simply replicate the same taxes that Connecticut imposes outside of the reservation.[107]

Planning. Nonmember businesses contemplating Indian country investments should remember that the tribe, like any government, is free to change its tax laws at any time. The ability of the tribe to alter its tax structure can lead to disadvantageous results for nonmember businesses operating on the reservation. For example, in *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1982), nonmember oil and gas companies entered into long-term leases with the tribes, allowing the companies to extract oil and gas from tribal lands. Subsequently, the tribe enacted a severance tax on the extraction of oil and gas. This tax applied on top of the lease payments that the nonmember companies had negotiated with the tribe. The Court held that the tribe's severance tax was valid in accordance with the tribe's sovereign power of taxation. To avoid a similar result, nonmembers making significant, long-term agreements with tribes may wish to negotiate contractual terms addressing the future tribal taxation of the nonmembers' on-reservation activities.

STATE TAXATION OF NONMEMBERS DOING BUSINESS IN INDIAN COUNTRY

States are, in general, allowed to impose nondiscriminatory taxes on nonmembers doing business on Indian reservations located within the state's borders.[108] States may not, however, tax nonmembers doing business in Indian country if federal law has preempted such taxation.[109] Such preemption need not be explicit; extensive federal regulation of the activity sought to be taxed may be sufficient.

In *White Mountain Apache Tribe v. Bracker*, 448 U.S. 136 (1980), the Supreme Court noted it must apply a balancing test involving a "particularized inquiry into the nature of the state, federal, and tribal interests at stake" to determine whether federal regulation had preempted a state tax. In *Bracker*, the Court held that the federal government had heavily regulated nonmember timber activity in Indian country, thus preempting a state tax on timber. The Court has recently ruled, however, that the balancing test articulated in *Bracker* will not apply if the nonmember is taxed on a transaction occurring off the reservation.[110] A state tax on a nonmember on off-reservation activity is therefore likely to be upheld.

Thus, in many instances a nonmember doing business in Indian country may be subject to both tribal and state taxation. For example, an oil extractor may be subject to both tribal and state severance taxes.[111] Had the extractor been operating outside of the reservation, it would have been subject to only one tax—the state tax. Businesses considering investments in In-

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[102] Mashantucket Pequot Tribal Law, title XVI, ch. 2. The Mashantucket tribal laws are available at www.mptnlaw.com.

[103] *Id.*, ch. 3.

[104] *Id.*, ch. 4.

[105] *Id.*, ch. 5.

[106] *Id.*, ch. 6.

[107] See Conn. Gen. Stat. Ann. section 12-408(1) (imposing a 6% sales tax on retail sales); *id.*, section 12-407(a)(2)(E) (indicating that the serving of meals and beverages is subject to the 6% sales tax imposed by section 12-408); *id.*, section 12-408(1) (increasing the rate of the sales tax to 12% on the occupancy of hotel rooms); *id.*, section 12-541 (imposing a 10% admissions tax on entertainment venues).

[108] See, e.g., Washington v. Confederated Tribes of Colville Indian Reservation, *supra* note 56 (upholding a state cigarette tax on nonmembers even where the tribe imposed its own tax on such sales); Moe v. Confederated Salish and Kootenai Tribes of the Flathead Reservation, *supra* note 57 (also upholding a state cigarette tax on nonmembers purchasing cigarettes on the reservation because the legal incidence of the tax fell on the nonmember purchasers).

[109] See, e.g., Warren Trading Post v. Arizona State Tax Comm'n, 380 U.S. 685 (1965) (striking down a state tax on a non-Indian trader doing business on the reservation because the tax was impliedly preempted by detailed federal regulation of traders doing business in Indian country).

[110] Wagnon v. Prairie Band Potawatomi Nation, 546 U.S. 95 (2005) (the Court refused to apply the balancing test and upheld a state fuel tax on nonmember distributors that was charged before the fuel was brought onto the reservation).

In addition to federal preemption, Indian tribes have argued that state taxes on nonmembers in Indian country should be struck down if they pose a threat to tribal self-government. See White Mountain Apache Tribe v. Bracker, 448 U.S. 136 (1980). The Court has relegated such concerns to the background and tends to focus on the issue of federal preemption in deciding whether state taxes on nonmembers in Indian country are valid. See *id.* (noting that tribal sovereignty has become a mere "backdrop" in analyzing state taxing powers in Indian country); McClanahan v. State Tax Comm'n of Ariz., *supra* note 57 (noting that "the trend has been away from the ideal of inherent Indian sovereignty as a bar to state jurisdiction"). For further discussion, see Cowan, "Double Taxation," *supra* note 2, page 110.

[111] See, e.g., Cotton Petroleum Corp. v. New Mexico, 490 U.S. 163 (1989) (upholding both state and tribal severance taxes on the production of oil and gas on reservation land by nonmembers).

dian country need to be aware of this possibility of double taxation.

Fortunately, some states and tribes have recognized the inequities of the double taxation problem in Indian country and have entered into compacts to ameliorate the situation.[112] There are over 200 state-tribal taxation compacts currently in place.[113] Under these compacts, nonmembers doing business in Indian country typically will have to pay only one layer of taxation, with the state and tribe splitting the revenue.[114] Thus, nonmembers contemplating investments in Indian country should research whether a compact is in force for the reservation and state in which they will be doing business.

CONCLUSION

As Indian tribes continue to expand their commercial operations, more non-Indian businesses will be operating on Indian reservations. To properly evaluate and negotiate potential investments in Indian country, such businesses must have a clear picture of the federal, state, and tribal tax rules that will apply to themselves and to the tribes and tribal members they will be dealing with. Practitioners must research any applicable tribal tax codes, assess the potential for double taxation (including the impact of any state-tribal tax compacts which address such double taxation), and determine if the client can structure its operations so as to take advantage of the federal accelerated depreciation and employment tax credit provisions. Only by understanding the tax cost (or benefit) involved can a business fully evaluate the efficacy of venturing into Indian country. ■

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112 For a discussion of tribal-state cooperation agreements or compacts in general, see Cohen's Handbook, *supra* note 2, at § 6.05.

113 *Id.* at § 8.05.

114 See Cowan, Double Taxation, *supra* note 2, pages 133-34. For an example of the detailed provisions of a compact, see Kenny et al., "Negotiations of Tax Compacts for Developing Standards of State Taxation in Indian Country," State Tax Today, 2/14/05, page 29-16 (examining the tribal-state compact in Michigan).