# Taxation on Indian Reservations: To Balance or Not to Balance, That Is the Question

*By James M. Susa*[1]

James Susa explains how new federal regulations could bring about big changes to the way tax issues on Indian reservations are handled.



## Introduction

The ability of the states to impose a tax upon transactions occurring on an Indian reservation has evolved substantially in the past 50 years. After numerous court decisions, the Indian preemption doctrine was fairly well established in the United States, and many businesses, tribes, and tribal members conducted their affairs under those rules. State and local governments were also versed on the taxation rules for Indian reservation activity. However, on January 4, 2013, new federal regulations became effective which may, if interpreted broadly, create a landscape shift in the Indian preemption doctrine. The regulations are already the focus of two federal court proceedings, and thus judicial guidance as to the regulations' validity and breadth may be just months away.

## The Indian Preemption Doctrine Historical Background

Federal Indian law jurisprudence exploring the dichotomy between tribal sovereignty and state taxation on the reservation has come a long way since 1832 when Chief Justice Marshall noted that state laws could simply "have no force" in Indian country.[2] By 1980, the U.S. Supreme Court wrote that it had departed from the "no force" rule long ago.[3] Despite the progress of state regulatory authority on

**James M. Susa** is of counsel with Snell & Wilmer L.L.P. in Tucson, Arizona.

the reservation, one barrier to state taxation on the reservation has endured.

In 1973, the U.S. Supreme Court recognized, "[T]he trend has been away from the idea of inherent Indian sovereignty as a bar to state jurisdiction and toward reliance on federal preemption."[4] In 1980, the Court established the Indian preemption doctrine as a balancing test that weighed the different interests of the federal, tribal, and state governments before deciding if state action upon the reservation was appropriate.[5] Due to the unique status of Indian tribes being neither states nor full sovereigns, the Indian preemption analysis is different than that found in other areas of the law. For example, the Indian preemption analysis is analyzed against the backdrop of tribal sovereignty, ambiguities that arise in federal law are construed in favor of the tribe, and lastly, federal law does not need to expressly preempt a state law in order for the state law to be preempted.[6]

In 1982, the Court applied the balancing test to the taxation of a reservation construction project.[7] In that case, a non-Indian contractor entered into a contract with a tribal entity to build a school on the reservation for Indian children to attend. In weighing the different federal, state and tribal interests, the Court held that New Mexico's gross receipts tax was preempted because the federal interest in furthering Indian education on the reservation outweighed the nominal interests asserted by the state in collecting tax revenue. Indian preemption is highly fact-specific and is decided on a case-by-case basis as federal, tribal, and state interests vary in each case. This has led to some clear lines in the area of state and local taxation.

One clear line is when the state tax falls directly on the tribe or tribal members. When that happens, a categorical approach replaces the Indian preemption analysis.[8] Under the Court's decision in *Oklahoma Tax Commission v. Chickasaw Nation*,[9] states are categorically precluded from directly taxing tribes and tribal members. Notably, some states such as Arizona and New Mexico have gone even further and taken the initiative to preclude state taxation of non-Indians performing otherwise taxable activities for a tribe or tribal member.



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## Taxation of Construction Contracts on the Reservation

### General Background

Most states only impose their sales tax on the sale of tangible personal property by a retailer, and thus the business activities of contractors are not within their tax scheme. Arizona and New Mexico impose sales taxes upon a number of business activities, including the work performed by contractors.[10] In Arizona, a contractor performing work on the reservation is exempt from the state sales tax if the construction is performed for the tribe or a tribal member, even if the contractor is non-Indian.[11] Importantly, the contract must be between the contractor and the tribe or a tribal member for the exemption to apply. Moreover, the tribal member must be a member of the tribe upon whose reservation the construction is being performed, and the tribe that has entered into a contract must have the construction activities take place upon the reservation established for that tribe to be exempt from tax.

In Arizona Department of Revenue Private Taxpayer Ruling LR95-015,[12] a contractor entered into a contract with a tribe to build an irrigation system on its reservation. The department held that the contract was exempt from the Arizona sales tax because the contractor performed construction for the tribe. Contrastingly, in *Arizona Department of Revenue v. Greenberg Construction*,[13] a contractor entered into a contract with several Arizona school districts, political subdivisions of the state, in order to build schools on the reservation. The court held that the contract was not exempt from state taxation because construction was not being performed for the tribe or tribal member; instead, it was being performed for the state.

In New Mexico, contractors who enter into contracts with tribes or tribal members on the reservation in New Mexico are also exempt from New Mexico's sales tax by statute.[14] This holds true as long as the construction is performed for a tribe or a tribal member upon whose reservation the construction is being performed. According to the New Mexico Taxation and Revenue Department's FYI-105, "[F]ederal law prohibits the application of state and local gross re-

ceipts tax to many transactions with Indian nations, tribes or pueblos or their agencies or members if the transaction takes place on the tribe's territory."[15]

## Indian-Owned Contractors in Arizona and New Mexico

Because states are categorically precluded from imposing a tax on tribes and tribal members, contractors that are "Indian-owned" are naturally exempt from state taxation on the reservation.[16] But 51-percent Indian-ownership is not enough to automatically be exempt. In Arizona, a contractor needs to demonstrate more to be exempt. Borrowing the federal definition for "Indian economic enterprise,"[17] Arizona courts have found that the contractor must not only assert its Indian ownership, but its Indian owners must also control the organization, participate in the daily management of the business, and gain the majority of the earnings of the contractor for the exemption to apply.[18] Further, the Indian owners must actually be members of the tribe upon whose reservation the construction is being performed.[19]

Daily management has also been a source of contention. In Private Taxpayer Ruling 2002 WL 32157122, the Arizona Department of Revenue held that the contractor was not exempt from state taxation because, although the contractor was 51-percent Indian-owned, the Indian owners did not actually control the management and operation of the business. The company operating agreement delegated the majority of the management and decision-making responsibilities to the non-Indian manager.[20]

The requirements for an Indian-owned contractor in New Mexico are remarkably different. In New Mexico, 51-percent Indian ownership of a contractor alone is sufficient for the contractor to be exempted from state taxation, as long as the Indian owners are members of the tribe upon whose reservation the construction is being performed.[21] In *Eastern Navajo Industries, Inc. v. Bureau of Revenue*,[22] a 51-percent Indian-owned contractor contracted with the Navajo Housing Authority to build homes on the reservation. The court held that the contractor was considered Indian-owned because 51 percent of its stock was owned by Indians, and therefore the contractor was exempt from New Mexico's sales tax.

## Federal Government Contractors for Reservation Work Taxable

Contracts with the federal government for construction performed on the reservation are always subject to state taxation, regardless of the nature of the construction project.[23] In the landmark case *United States v. New Mexico*,[24] the Court held that contractors who contract with the federal government to perform construction work can be taxed by the state because they are not "constituent parts" of the federal government and therefore are not protected by federal immunity to taxation. This bright-line rule was extended in *Arizona Department of Revenue v. Blaze Construction Company*[25] to construction work performed for the federal government on an Indian reservation. In *Blaze*, a non-Indian contractor contracted with the Bureau of Indian Affairs to perform construction on the reservation. The Court held that the contractor was not exempt from state taxation under the bright-line rule set forth in *United States v. New Mexico*.

## New Regulations Published by the Secretary of the Interior

Effective January 4, 2013, the new regulations[26] entitled "Residential, Business, and Wind and Solar Resource Leases on Indian Land," comprise the most comprehensive reform to nonagricultural surface leasing on Indian land in over 50 years.[27] The purpose of the new regulations is to expedite the approval of leases by the Bureau of Indian Affairs, advance economic development generally, and propel renewable energy development on Indian lands, ultimately improving well-being overall and tribal self-government. While most of the new regulations are aimed at making the leasing process more efficient, the Department of the Interior also published 25 C.F.R. § 162.017 in furtherance of economic development on the reservation. If read broadly, 25 C.F.R. § 162.017 dispenses completely with the Indian preemption doctrine balancing test and creates a "tax-free zone" from state and local taxation on Indian land.

The regulations language is as follows:

> § 162.017 What taxes apply to leases approved under this part?
>
> (a) Subject only to applicable Federal law, permanent improvements on the leased land, without regard to ownership of those improvements, are not subject to any fee, tax, assessment, levy, or other charge imposed by any State or political subdivision of a State. Improvements may be subject to taxation by the Indian tribe with jurisdiction.

(b) Subject only to applicable Federal law, activities under a lease conducted on the leased premises are not subject to any fee, tax, assessment, levy, or other charge (e.g., business use, privilege, public utility, excise, gross revenue taxes) imposed by any State or political subdivision of a State. Activities may be subject to taxation by the Indian tribe with jurisdiction.

(c) Subject only to applicable Federal law, the leasehold or possessory interest is not subject to any fee, tax, assessment, levy, or other charge imposed by any State or political subdivision of a State. Leasehold or possessory interests may be subject to taxation by the Indian tribe with jurisdiction.

The most immediate reaction to the regulations is whether the Department of the Interior has the authority to issue regulations preempting state and local taxation on a reservation without some specific federal statute addressing the same subject. Congress generally has authorized the Executive Branch to promulgate regulations related to Indian affairs.[28] Specifically, the Bureau of Indian Affairs, under the purview of the Secretary of the Interior, is provided authority for "the management of all Indian affairs and of all matters arising out of Indian relations."[29] With this authority comes the responsibility to approve leases of Indian land.[30] The regulations establish procedures for such approval, as well as those for the administration of the leases. However, the statute did not delegate to the Secretary of the Interior the authority to preempt state and local taxes for activities on leased Indian land. Nevertheless, the regulations do exactly that if read broadly, which the regulation's preamble implies should be done.

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The regulation's preamble explains how the regulations are consistent with the balancing test set out by the U.S. Supreme Court.[31] In applying the balancing test to the area of leasing on Indian lands, the Department of the Interior has determined that federal law with respect to Indian leasing is so comprehensive that it preempts state and local taxation. This determination eliminates the need for the Indian preemption doctrine's balancing test. According to the department, the test's balancing scale will always tip in favor of federal and tribal interests, preempting state and local taxation.[32]

The problem with this approach is that the scope of the phrase "[s]ubject only to applicable federal law" is ambiguous. The preamble notes that "federal law" includes Supreme Court decisions.[33] Several Supreme Court decisions have upheld state taxation of activities conducted pursuant to Indian leases.[34] If the regulations yield to "federal law" and Supreme Court decisions have established the Indian preemption doctrine as a balancing test, then how could the regulations eliminate the balancing test in favor of always preempting state and local taxation? Is a federal agency, under its broad power to establish regulations, able to overturn by regulation a Supreme Court decision?

Further, while federal law "includes" Supreme Court decisions, does that infer that it may include other lower court decisions on the subject? In *Yavapai-Prescott Indian Tribe v. Scott,*[35] the U.S. Court of Appeals upheld state taxation of sales between non-Indians on the reservation. The same result occurred in *Gila River Indian Community v. Waddell*[36] and *Salt River Pima-Maricopa Indian Community v. State of Arizona,*[37] both from the same federal appeals court.

Not surprisingly, both the validity and meaning of the regulations are already being tested in two federal courts. The regulations have been cited by a tribe in western Washington in a case in the United States Court of Appeals involving the issue of whether a county is barred from imposing a property tax on permanent improvements on Indian reservation land.[38] Additionally, the Desert Water Agency ("DWA") in California filed suit in the U.S. District Court for the Central District of California against the Department of the Interior and the Bureau of Indian Affairs, alleging that the regulations do not preclude DWA from imposing its charges upon non-Indian lessees on the reservation, but that if it does, the regulation is arbitrary and capricious and exceeds the Department of the Interior's and the Bureau of Indian Affairs' authority under federal law.[39]

## Conclusion

The Indian preemption doctrine has been fashioned by the courts for many decades and provides a balancing test of federal, tribal, and state interests to be applied to determining the validity of state and local taxation to transactions upon the reservation. With an extensive body of case law, the rules were clear enough that those involved in taxation on Indian reservations had fair warning of what their tax liabilities might be. In January, this entire taxation scheme was unceremoniously disturbed by regulations adopted by the Department of the Interior. Soon, hopefully, federal courts will clarify the regulation's validity and reach.

### Endnotes

[1] The author wishes to thank Katya M. Lancero, Snell & Wilmer L.L.P. Minority Writing Program Intern for her significant research on the subject matter.

[2] *Worcester v. Georgia*, SCt, 31 US 515, 520 (1832).

[3] *White Mountain Apache Tribe v. Bracker*, SCt, 448 US 136, 141, 100 SCt 2578 (1980).

[4] *McClanahan v. Arizona State Tax Commission*, SCt, 411 US 164, 172, 93 SCt 1257 (1973).

[5] *White Mountain Apache Tribe v. Bracker*, SCt, 448 US 136, 145, 100 SCt 2578 (1980).

[6] *Id.* at 143-45.

[7] *Ramah v. Navajo School Board*, SCt, 458 US 832, 102 SCt 3394 (1982).

[8] *Oklahoma Tax Commission v. Chickasaw Nation*, SCt, 515 US 450, 115 SCt 2214 (1995).

[9] *Id.*

[10] Arizona imposes a transaction privilege tax while New Mexico imposes a gross receipts tax. Both differ from a traditional sales tax in that they apply to numerous categories of business activity (instead of just the sale of tangible personal property at retail), and the legal incidence of the tax is upon the business, not the customer.

[11] Transaction Privilege Tax Ruling 95-11 (1995).

[12] Priv. Tax. Rul. 95-015, 1995 WL 17017095.

[13] *Arizona Department of Revenue v. Greenberg Construction*, 182 Ariz. 397 (App. 1995).

[14] N.M. Code R. § 3.2.4.9(E).

[15] New Mexico Taxation and Revenue Dep't FYI-105, 8, available at: *www.tax.newmexico.gov/SiteCollectionDocuments/Publications/FYI-Publications/FYI-105__GROSS%20RECEIPTS%20and%20COMPENSATING%20TAXES%20-%20AN%20OVERVIEW%202009.pdf.*

[16] *Oklahoma Tax Commission v. Chickasaw Nation*, SCt, 515 US 450, 115 SCt 2214 (1995).

[17] 25 CFR § 286.3 (2013).

[18] Private Taxpayer Ruling 2002 WL 32157122.

[19] *Blaze Constr. Co.*, 526 U.S. at 34.

[20] Priv. Tax. Rul. 2002 WL 32157122.

[21] *Eastern Navajo Industries, Inc. v. Bureau of Revenue*, 89 N.M. 369 (1976).

[22] *Id.*

[23] *Arizona Department of Revenue v. Blaze Construction Company*, SCt, 526 US 32, 119 SCt 957 (1999).

[24] *United States v. New Mexico*, SCt, 455 US 720, 102 SCt 1373 (1982).

[25] *Arizona Department of Revenue v. Blaze Construction Company*, SCt, 526 US 32, 119 SCt 957 (1999).

[26] 25 CFR § 162 (2012).

[27] Press Release, U.S. Department of the Interior, Salazar Finalizes Reforms to Streamline Leasing, Spur Economic Development on 56 Million Acres of American Indian Trust Land (Nov. 27, 2012).

[28] *James v. U.S. Dep't of Health & Human Services*, (DC D.C.) 824 F2d 1132 (1987).

[29] 25 USC § 2.

[30] 25 USC § 415.

[31] 77 Fed. Reg. 72440, 72447 (Dec. 5, 2012).

[32] *Id.*

[33] *Id.* ("Tribes have inherent plenary and exclusive power … which has been subject to limitations imposed by Federal law, *including but not limited to Supreme Court decisions*") (emphasis added).

[34] *See Cotton Petroleum v. New Mexico*, SCt, 490 US 163, 109 SCt 1698 (1989) (upholding state taxation of oil and gas under a tribal oil and gas lease).

[35] *Yavapai-Prescott Indian Tribe v. Scott*, (CA-9) 117 F3d 1107 (1997).

[36] *Gila River Indian Community v. Waddell*, (CA-9) 91 F3d 1232 (1996).

[37] *Salt River Pima-Maricopa Indian Community v. State of Arizona*, (CA-9) 50 F3d 734 (1995).

[38] *Confederated Tribes of the Chehalis Reservation v. Thurston County Board of Equalization*, (CA-9) United States Court of Appeals, No. 10-35642.

[39] *Desert Water Agency v. U.S. Department of the Interior*, United States District Court, (DC Cal.) No. 13-CV-00606-DMG-OP.