

Native Americans and Tribes Face Unsettling Tax Issues

By Robert W. Wood



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<http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Native Americans and Native American tribes are increasingly involved in federal tax matters, both administratively and in litigation. Wood looks at the mix of individual and tribal concerns, much of it fueled by gambling revenues.

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There are many corners of our vastly complicated federal tax system that are foreign to most tax advisers. Myriad special rules address entities such as agricultural cooperatives, life insurance companies, mutual savings banks, regulated investment companies, export trade corporations, and more. The federal tax law applicable to Native American tribes and their members may be among the least understood, although that may be changing.

For the most part, the tax rules governing Native American tribes and their members are settled. Yet tribal and individual tax controversies are arising and issues are being reexamined. Native Americans are criticizing the IRS, while non-Native gambling businesses have called for wholesale changes to the taxation of gambling.

The prominence of the Native American gambling industry means there are significant dollars to consider. This is of comparatively recent origin. The

Indian Gaming Regulatory Act of 1988 (IGRA)¹ created a regulatory framework for legal gambling on Native American lands. From it sprang the National Indian Gaming Commission, an independent regulatory body composed of three full-time members located within the Interior Department. It has general oversight responsibility for the Native American gambling industry.

The IGRA facilitated the growth of the Native American gambling industry, which today provides revenues for many tribes. In 2008 gambling industry participants included more than 240 of the nation's 562 Native American tribes, producing approximately \$26.7 billion in revenues at more than 400 casinos and bingo halls in 28 states.²

Sovereignty

Native American tribes are sovereign nations, a classification that affects their tax treatment and many other laws. As Chief Justice John Marshall put it, they are "domestic dependent nations."³ The tribes are "distinct political communities, having territorial boundaries, within which their authority is exclusive, and having a right to all the lands within those boundaries."⁴

Native American tribes have the sovereign power to tax "members of the tribe and . . . nonmembers, so far as such nonmembers may accept privileges of trade, residence, etc., to which taxes may be attached as conditions."⁵ The tribes may have the *power* of taxation, but tribes themselves are not taxed. Just as the U.S. government does not tax France or Germany, it does not tax Native American tribes.

Since federally recognized tribes are not taxable entities, they are exempt from U.S. income taxes. This tax exemption applies regardless of whether the activities that produced the income are commercial or noncommercial in nature or are conducted on or off the reservation.⁶ Also, tribal corporations

¹25 U.S.C. section 2710, et seq., P.L. 100-497 (Oct. 17, 1988).

²Press release, National Indian Gaming Commission, "National Indian Gaming Commission Announces Indian Gaming Revenues for 2008" (June 3, 2009).

³See *Cherokee Nation v. Georgia*, 5 Pet. 1, 18 (1831).

⁴*Worcester v. Georgia*, 6 Pet. 515, 557 (1832).

⁵*Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134 (1980) (quoting *Powers of Indian Tribes*, 55 I.D. 14, 46 (1934)).

⁶See Rev. Rul. 67-284, 1967-2 C.B. 55.

organized under section 17 of the Indian Reorganization Act of 1934 share the same tax status as a Native American tribe. They too are not taxed on income arising from activities carried on within the boundaries of the reservation.⁷

The tax treatment of tribes creates tension between federal and state governments, limiting the extent to which the states can tax tribes. Native American tribes are generally exempt from state taxation within their reservations and remain so unless Congress clearly manifests its consent to that taxation.⁸ However, outside the boundaries of their reservations, Native American tribes can be subject to taxation by the states.⁹

Individual Native Americans

Despite the tax-exempt status of tribes, individual Native Americans are U.S. citizens and, like other citizens, are subject to federal income taxes.¹⁰ This is true even if the income is distributed by a tribe and is otherwise tax exempt when received by the tribe. However, absent an express authorization from Congress, states do not have the power to tax Native Americans living on a reservation on income derived from reservation sources.¹¹

This protection is subject to geographical restrictions. A state may tax only the income (including wages from tribal employment) of Native Americans residing in the state *outside* their reservations.¹² This leads to inevitable line-drawing. Further complicating the scene, some types of income earned by members of Native American tribes are not subject to federal tax.

One type is income earned from the exercise of specific fishing rights. Also excluded from tax are payments in satisfaction of a judgment of the Court of Federal Claims in favor of a tribe, which are then distributed per capita to tribal members under a plan approved by the secretary of the Interior. Per capita distributions made to tribal members from some Native American trust funds are excluded as well.

Another type of excluded income is that derived directly from land held in trust by the federal government for the benefit of a Native American tribe or a member. Income is derived directly from trust land if it is generated principally from the use of reservation land and resources rather than from

capital improvements on the land. It includes income from logging, mining, farming, or ranching activities.

Thus, in Notice 2012-60¹³ the IRS recently exempted from income taxation some per capita payments that members of Native American tribes received from settlements of tribal trust cases between the United States and those tribes. The notice considers settlements of litigation in which the tribes alleged that Treasury and the Interior Department mismanaged monetary assets and natural resources that the United States holds in trust for the benefit of the tribes.¹⁴

Applying the origin of the claim test, the IRS noted that the tribes asserted that absent alleged mismanagement of their trust funds and resources, their government-administered trust fund accounts would have had substantially larger balances. The settlement was therefore viewed as trust funds and exempt from tax, even when distributed per capita to members of the tribes. Substantially similar settlements of claims brought by other federally recognized tribes are anticipated and will presumably receive the same tax treatment.

Gambling and Taxation

Gambling on Native American lands is a major source of tribal revenue. According to the Joint Committee on Taxation, in 2011 Native American gambling was a \$26.5-billion-per-year industry. A total of 236 Native American tribes operate 422 casinos spread across 28 states.¹⁵

Before the implementation of the IGRA, there was considerable confusion regarding the states' authority to regulate gambling activities on Native American land. Those disputes came to a head in *California v. Cabazon Band of Mission Indians*.¹⁶ There, the Supreme Court used a balancing test between federal, state, and tribal interests. The Court held that in states that otherwise allowed gambling, tribes had a right to conduct gambling activities on Native American lands largely unhindered by state regulation.

A year after *Cabazon*, Congress enacted the IGRA. Its express purpose was "to provide a statutory basis for the operation of gaming by Indian tribes as

⁷Rev. Rul. 81-295, 1981-2 C.B. 15.

⁸See *County of Yakima v. Confederated Tribes & Bands of the Yakima Indian Nation*, 502 U.S. 251, 258 (1992).

⁹See *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973).

¹⁰See *Squire v. Capoeman*, 351 U.S. 1, 6 (1956).

¹¹See *McClanahan v. Arizona State Tax Commissioner*, 411 U.S. 164 (1973).

¹²See *Oklahoma Tax Commission v. Chickasaw Nation*, 515 U.S. 450, 453 (1995), *Doc 95-5981*, 95 TNT 116-17.

¹³2012-41 IRB 445, *Doc 2012-18686*, 2012 TNT 174-5.

¹⁴See press release, Justice Department, "Attorney General Holder and Secretary Salazar Announce \$1 Billion Settlement of Tribal Trust Accounting and Management Lawsuits Filed by More Than 40 Tribes" (Apr. 11, 2012).

¹⁵See JCT, "Overview of Federal Tax Provisions and Analysis of Selected Issues Relating to Native American Tribes and Their Members," JCX-40-12, at 21 (May 14, 2012), *Doc 2012-10315*, 2012 TNT 94-23, which serves as a basis for much of the material covered here.

¹⁶480 U.S. 202 (1987).

a means of promoting tribal economic development, self-sufficiency, and strong tribal governments."¹⁷ Notably, the IGRA expressly rejected the states' arguments that they should be allowed to regulate tribal gambling businesses.

Despite the large dollars involved and the complex web of federal regulation governing gambling, Native American tribes and their wholly owned tribal corporations are generally not subject to federal income tax on the earnings from their gambling activity. Likewise, those earnings aren't subject to taxation at the state level. However, there have been efforts to legislate federal income tax on Native American tribes on income arising from casinos, bingo, lottery, and other gambling operations.¹⁸

One of the more complicated provisions of the IGRA permits Native American tribes to make per capita distributions of revenue derived from gambling activities to tribe members. However, consistent with the general rules allowing the federal taxation of individual tribal members' income, the IGRA subjects the receipt of those per capita distributions to federal income tax.¹⁹ Yet there are other tribal tax implications of gambling.

Although federally recognized Native American tribes and wholly owned tribal corporations chartered under federal law are exempt from income taxation, they are subject to federal excise taxes on wagering. The wagering excise taxes are not included in the list of excise taxes for which tribal governments are treated as states. The Supreme Court has held that Native American tribes are subject to these taxes even though the states are exempt.²⁰

Gambling is big business. The dollars at stake related to gambling can lead to disputes even when the tribes and their members are not the taxpayers. In those cases, the tension can be palpable. In a recent court battle, the IRS sought to subpoena banks as part of its examination of a Florida Native American tribe's financial records.

The dispute arose out of an IRS investigation over federal tax withholding and reporting requirements on gambling profits distributed to 600 members of Florida's Miccosukee tribe from 2006 to 2009. In *Miccosukee Tribe of Indians of Florida v. United*

States,²¹ the Miccosukee tribe claimed protection under sovereign immunity. Nevertheless, the district court and the Eleventh Circuit held that the IRS *can* subpoena bank records.

Although the tribe is tax exempt, the tribe must deduct and withhold income taxes from gambling revenues paid to tribal members. According to the case, the tribe failed to comply with its tax obligations from 2000 to 2005. That triggered an IRS investigation into tribal finances from 2006 to 2009.

When the tribe refused to hand over the records, the IRS subpoenaed them from four banks. In addition to invoking sovereign immunity, the tribe argued that the records would reveal confidential financial information and force it to change its banking practices. The court rejected all the tribe's arguments, noting that the Miccosukee tribe gave the information to the banks, so the records were the property of the banks, not the tribe.

The Miccosukee tribe has acknowledged that at least 100 Miccosukee members owe the IRS more than \$25 million in back taxes, penalties, and interest. Other tribes have also faced difficult, sensitive, and expensive interactions with the IRS. We can expect there to be more frequent disputes between the IRS and Native American tribes and their members.

General Welfare Exception

Although per capita distributions are generally taxed to individual Native Americans, the general welfare exception from income (GWE) has come to be important to many Native Americans. The GWE exempts from income some payments made to individuals, and it has been applied to Native Americans as well as non-Native Americans. The payments must be made under legislatively provided social benefit programs for the promotion of general welfare.²²

Given our statute-based tax law, many tax professionals are surprised to learn that the GWE is not an exception contained in the Internal Revenue Code. It is an administrative exclusion that has been developed in official IRS guidance and been recognized by the courts and Congress over a 55-year period.²³ In general, to be excludable under the GWE, a payment must: (1) be made under a governmental program, (2) be for the promotion of general welfare (that is, be based generally on

¹⁷25 U.S.C. section 2702.

¹⁸See Robert Pear, "Small Items in Budget Bills Yield Big Benefits for Special Interests," *The New York Times*, Nov. 6, 1995, at A1.

¹⁹See 25 U.S.C. section 2710(b)(3)(D).

²⁰See *Chickasaw Nation v. United States*, 534 U.S. 84 (2001), *Doc 2001-29463*, 2001 TNT 229-6 (holding that the IGRA does not exempt tribal governments from federal excise taxes on wagering in the same manner as states).

²¹No. 11-14825 (11th Cir. 2012), *Doc 2012-21267*, 2012 TNT 200-7.

²²See, e.g., Rev. Rul. 76-395, 1976-2 C.B. 16.

²³See, e.g., Rev. Rul. 63-136, 1963-2 C.B. 19; *Graff v. Commissioner*, 673 F.2d 784 (5th Cir. 1982), *aff'd per curiam* 74 T.C. 743 (1980); *Bailey v. Commissioner*, 88 T.C. 1293 (1987).

individual, family, or other needs), and (3) not represent compensation for services.²⁴

The GWE has been applied to a wide variety of social benefit programs. For example, it excludes from gross income state payments to needy adoptive parents to assist in raising adopted children.²⁵ It also covers payments made by a city to residents moving from flood-damaged residences to other residences.²⁶

Concerning Native Americans, LTR 200409033²⁷ addressed a tribe that provided educational assistance and benefit payments to its members who attended institutions of higher learning and vocational or occupational training. Most tribal members qualifying for assistance had an income below the national family median income level. The IRS ruled that the educational assistance payments were made to enhance educational opportunities for students from lower-income families. The payments were excluded from gross income because they were for the promotion of general welfare.

Similarly, in a 1967 letter ruling²⁸ the IRS ruled that payments to participants in a tribal program designed to train unemployed and underemployed residents in construction skills were excluded from income under the GWE. The primary purpose was training, which is based on the need for additional skills to prepare for the job market. The payments were not for services.

Recently, in Notice 2011-94,²⁹ the IRS invited comments concerning the application of the GWE to Native American programs. Some tribes have accused the IRS of performing discriminatory audits of Native American tribes or members. Randall Vicente, governor of the Pueblo of Acoma tribe in New Mexico, complained that IRS agents in recent

audits have attempted to reclassify GWE payments as taxable IGRA per capita distributions.³⁰

If the payments are provided under a bona fide social benefit program, they should not be considered IGRA per capita payments even if the benefits are provided on a communitywide or tribalwide basis. Vicente's comments in response to Notice 2011-94 suggest a fundamental tension between federal oversight of the Native American gambling industry and the broad exclusion of social benefit programs under the GWE. More discussion of this issue and other tax subjects surrounding Native Americans seem likely.

Conclusion

The taxation of Native American individuals and tribes is becoming increasingly important. The IRS is being asked to administer and interpret these rules, as are the courts. Testifying before the Senate Finance Committee, Sarah Hall Ingram, commissioner of the IRS Tax-Exempt and Government Entities Division, pledged that the Service would issue guidance as soon as possible. The IRS wants to provide clarity and certainty to Native American tribal governments and consistency in the application of the GWE, according to Ingram.³¹

The underlying principles of the GWE may seem simple, yet it has always been sparingly applied. Moreover, when applied regarding tribal revenues from the surge in gambling activity, it may not be so clear cut. The administration of the tax laws affecting Native Americans and tribes, even when they are not the taxpayers, will require more IRS energy in the future.

The matters noted here only scratch the surface of the tax issues affecting Native Americans and tribes. The federal income tax questions are more nuanced than this short summary suggests. Moreover, state sales and use, excise, income, and property taxes are all important. Many tax professionals can expect to hear more about this increasingly significant corner of the tax law.

²⁴See LTR 201127007, *Doc 2011-14855*, 2011 TNT 132-35.

²⁵See Rev. Rul. 74-153, 1974-1 C.B. 20.

²⁶See Rev. Rul. 98-19, 1998-1 C.B. 840, *Doc 98-10448*, 98 TNT 59-9.

²⁷*Doc 2004-3963*, 2004 TNT 40-26.

²⁸LTR 6706069340A.

²⁹2011-49 IRB 834, *Doc 2011-23988*, 2011 TNT 221-17.

³⁰Comments of Randall Vicente (May 18, 2012), *Doc 2012-11635*, 2012 TNT 105-18.

³¹Testimony of Sarah Hall Ingram (May 15, 2012), *Doc 2012-10379*, 2012 TNT 95-44.