Native American Tax Rules Are Increasingly Important

by Robert W. Wood

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In this article, Wood surveys the current Native American tax landscape in light of the special tax rules for tribes and tribal members.

This discussion is not intended as legal advice.

The federal tax rules governing Native American tribes and their members may be among the least understood parts of the tax law. There are some well-established rules, but there have also been more recent changes. For example, the Tribal General Welfare Exclusion Act of 2014 (P.L. 113-168) clarified the taxation of tribal members, giving them much more concrete tax protection.

And with the recent *Wayfair* decision[1] affecting state sales taxes, one might expect Native American tribal sovereignty to once again be discussed. Amazon founder Jeff Bezos is reported to have once considered locating his company on tribal lands in view of potential tax advantages.

And then there is the subject of Native American gaming.

The Indian Gaming Regulatory Act of 1988 (IGRA, 25 U.S.C. section 2710 et seq., P.L. 100-497) created a regulatory framework for legal gambling on Native American lands, including the National Indian Gaming Commission, an independent regulatory body composed of three full-time members within the Interior Department with general oversight responsibility for Native American gaming. IGRA facilitated the growth of the Native American gaming industry, which today provides revenues for many tribes. In 2016 gaming industry participants included more than 244 of the nation's 562 Native American tribes, producing approximately $31.2 billion in revenue across 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 they aren't taxed. Just as the U.S. government doesn't tax

[1] *South Dakota v. Wayfair Inc.*, No. 17-494 (2018).

[2] National Indian Gaming Commission release on 2016 increase in Indian gaming revenues (July 17, 2017).

[3] *See Cherokee Nation v. Georgia*, 30 U.S. 1, 18 (1831).

[4] *Worcester v. Georgia*, 31 U.S. 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)).

France or Germany, it doesn't tax Native American tribes.

Since federally recognized tribes aren't 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] Tribal corporations organized under section 17 of the Indian Reorganization Act of 1934 share the same tax status as a Native American tribe. They too aren't taxed on income from activities carried on within the boundaries of the reservation.[7]

The treatment of tribes creates tension between federal and state governments because it limits how much the states can tax tribes. Native American tribes are generally exempt from state taxation within their reservations and remain so unless Congress clearly indicates its consent otherwise.[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 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, states don't have the power to tax Native Americans living on a reservation on income derived from reservation sources absent an express authorization from Congress.[11]

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

One such type is income earned from the exercise of specific fishing rights. Also excluded from tax are payments in satisfaction of a judgment of the U.S. Court of Federal Claims in favor of a tribe, which are then distributed per capita to tribal members according to a plan approved by the interior secretary. 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's generated principally from the use of reservation land and resources rather than from capital improvements upon the land. It includes income from logging, mining, farming, or ranching activities.

Thus, in Notice 2012-60, 2012-41 IRB 445, the IRS exempted from income taxation some per capita payments 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 the Interior Department and Treasury mismanaged monetary assets and natural resources that the United States holds in trust for the benefit of the tribes.[13]

Applying the origin of the claim test,[14] 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 expected and will presumably receive the same tax treatment.

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

[7] Rev. Rul. 81-295, 1981-2 C.B. 15.

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

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

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

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

[12] *See Oklahoma Tax Commission v. Chickasaw Nation*, 515 U.S. 450, 453 (1995).

[13] *See* Justice Department release on $1 billion settlement of tribal trust accounting and management lawsuits filed by more than 40 tribes (Apr. 11, 2012).

[14] Settlements and judgments are taxed according to the item for which the plaintiff was seeking recovery (the origin of the claim). *See, e.g.*, *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hort v. Commissioner*, 313 U.S. 28 (1941); *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

Gaming and Taxation

Gaming on Native American lands is a major source of tribal revenue. According to the National Indian Gaming Commission, in 2016 Native American gaming was a $31.2-billion-per-year industry, an overall increase of 4.4 percent from 2015. A total of 244 Native American tribes operate 484 casinos spread across 28 states.[15]

Before the implementation of IGRA, there was considerable confusion regarding the states' authority to regulate gaming activities on Native American land.[16] The disputes came to a head in *Cabazon*.[17] There, the Supreme Court used a balancing test between federal, state, and tribal interests. The Court held that in states that otherwise allowed gaming, tribes had a right to conduct gaming activities on Native American lands largely unhindered by state regulation.

A year after *Cabazon*, Congress enacted IGRA. Its express purpose was "to provide a statutory basis for the operation of gaming by Indian tribes as a means of promoting tribal economic development, self-sufficiency, and strong tribal governments."[18] Notably, IGRA expressly rejected the states' arguments that they should be allowed to regulate tribal gaming.

Despite the large dollar amounts involved and the complex web of federal regulation governing gaming, Native American tribes and their wholly owned tribal corporations generally aren't subject to federal income tax on the earnings from their gaming activity. Likewise, they 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 from casinos, bingo, lotto, and other gaming operations.[19]

One of the more complicated provisions of IGRA permits Native American tribes to make per capita distributions of revenue derived from gaming activities to tribe members. However, consistent with the general rules allowing the federal taxation of individual tribal members' income, IGRA subjects the receipt of those per capita distributions to federal income tax.[20]

Yet there are still other tribal tax implications of gaming. 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 aren't on 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.[21]

Gaming is big business. The dollars at stake can lead to disputes even when the tribes and their members aren't the taxpayers. In 2010 the IRS sought to subpoena banks as it was examining a Florida Native American tribe's financial records. The dispute arose from 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*,[22] the Miccosukee Tribe claimed protection under sovereign immunity. Nevertheless, the district court and the Eleventh Circuit Court of Appeals held for the IRS that the agency can subpoena bank records.

Although the tribe is tax exempt, it 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 arguing sovereign immunity, the tribe argued that the records would reveal confidential financial information and force it to change its banking practices. The court

[15] National Indian Gaming Commission, *supra* note 2.

[16] *See* Joint Committee on Taxation, "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) (serves as a basis for much of the material covered here).

[17] *California v. Cabazon Band of Mission Indians*, 480 U.S. 202 (1987).

[18] 25 U.S.C. section 2702.

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

[20] *See* 25 U.S.C. section 2710(b)(3)(D).

[21] *See Chickasaw Nation v. United States*, 534 U.S. 84 (2001) (holding that IGRA doesn't exempt tribal governments from federal excise taxes on wagering in the same manner as states).

[22] *Miccosukee Tribe of Indians of Florida v. United States*, 698 F.3d 1326 (11th Cir. 2012).

rejected all the tribe's arguments, noting that the Miccosukee Tribe had given 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 faced difficult, sensitive, and expensive interactions with the IRS. We can expect there to be more frequent interaction between the IRS and Native American tribes and their members in the future.

General Welfare Exception

Although per capita distributions are generally taxed to individual Native Americans, the general welfare exception from income (GWE) has become important to many Native Americans. The GWE exempts from income some payments made to individuals, and has been applied to Native Americans and others. The payments must be made under legislatively provided social benefit programs for the promotion of the general welfare.[23]

The GWE is an administrative exclusion that has been developed in official IRS guidance and recognized by the courts and Congress over a 55-year period.[24] 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 individual, family, or other needs); and (3) not represent compensation for services.[25]

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.[26] It also covers payments made by a city to residents moving from flood-damaged residences to other residences.[27]

Concerning Native Americans, in LTR 200409033, a tribe 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 the general welfare.

Similarly, in LTR 6706069340A, the IRS considered payments to participants in a tribal program designed to train unemployed and underemployed residents in construction skills. Here, too, the IRS ruled that the payments 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 weren't for services.

In Notice 2011-94, 2011-49 IRB 834, 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. In 2012 Randall Vicente, then-governor of the Pueblo of Acoma tribe in New Mexico, complained that IRS agents in audits had attempted to reclassify GWE payments as taxable IGRA per capita distributions.[28]

If the payments are provided under a bona fide social benefit program, they shouldn't be considered IGRA per capita payments, even if the benefits are provided communitywide or tribewide. Vicente's comments in response to Notice 2011-94 suggest a fundamental tension between federal oversight of Native American gaming and the broad exclusion of social benefit programs under the GWE.

The IRS received more than 85 comments to Notice 2011-94 from Native American tribal governments and other individuals and groups. The comments described tribal government programs and how the GWE should apply. In response, the IRS issued Notice 2012-75, 2012-51 IRB 715, which proposed a revenue procedure

[23] *See, e.g.*, Rev. Rul. 76-395, 1976-2 C.B. 16.

[24] *See, e.g.*, Rev. Rul. 63-136, 1963-2 C.B. 19; *Graff v. Commissioner*, 673 F.2d 784 (5th Cir. 1982), *affg. per curiam* 74 T.C. 743 (1980); *Bailey v. Commissioner*, 88 T.C. 1293 (1987).

[25] *See* LTR 201127007.

[26] *See* Rev. Rul. 74-153, 1974-1 C.B. 20.

[27] *See* Rev. Rul. 98-19, 1998-1 C.B. 840.

[28] *See* Letter from Vicente to the IRS, "Indian Tribes Ask IRS to Expand Application of General Welfare Exclusion" (May 18, 2012).

that would provide safe harbors under which the Service would conclusively presume that (1) the individual need requirement of the general welfare exclusion would be met for specific benefits provided under described Native American tribal governmental programs; and (2) specific benefits a Native American tribal government provides under other described programs aren't compensation for services.

In Rev. Proc. 2014-35, 2014-26 IRB 1110, the IRS provided that guidance. Rev. Proc. 2014-35 includes safe harbors under which the IRS will conclusively presume that the GWE need requirement is met and won't contend that payments represent compensation for services.

Then, on September 26, 2014, President Obama signed into law the Tribal General Welfare Exclusion Act, which added a new section 139E to the Internal Revenue Code to apply the GWE to Native American tribes and payments received by tribal members, their spouses, and dependents. Section 139E provides that gross income doesn't include the value of any Native American general welfare benefit if all the following requirements are satisfied:

- the program is administered under specific guidelines and doesn't discriminate in favor of members of the governing body of the tribe; and
- the benefits provided under the program are:
  - available to any tribal member who meets the guidelines;
  - for the promotion of general welfare;
  - not lavish and extravagant; and
  - not compensation for services.

The 2014 act provides further that any items of cultural significance, reimbursement of costs, or cash honorarium for participation in cultural or ceremonial activities for the transmission of tribal culture won't be treated as compensation for services.

The 2014 act requires that the tribal benefits provided be "for promotion of general welfare," but it doesn't include a definition of this term. In contrast, Rev. Proc. 2014-35 presumes that any tribal benefit falling within one of the enumerated general categories meets this requirement, even if the benefit program isn't based on need. Unlike the revenue procedure, the act doesn't limit its application to specific types or examples of tribal programs.

There has been some concern that the IRS could interpret the new statutory requirement that the benefits be "for promotion of general welfare" as requiring a determination of individual or family financial need (as the IRS has required in the past in evaluating tribal programs). However, the 2014 act's legislative history clarifies that Congress intended "that the IRS will apply this requirement in a manner no less favorable than the safe harbor approach provided for in Rev. Proc. 2014-35, and in no event will the IRS require an individualized determination of financial need where a Tribal program meets all other requirements of new section 139E as added by the bill."[29]

In April 2015 the IRS issued Notice 2015-34, 2015-18 IRB 942, to clarify its position on the effect of the 2014 act on Rev. Proc. 2014-35 and its safe harbors. Notice 2015-35, 2015-18 IRB 943, states that section 139E codifies, but doesn't supplant, the GWE. It also states that taxpayers may continue to rely on Rev. Proc. 2014-35.

Conclusion

The taxation of Native American individuals and tribes has become increasingly important, as have state sales and use taxes, excise taxes, state income taxes, and property taxes. Tax professionals should probably expect to hear more about this increasingly significant corner of the tax law. ■

[29] *See* Colloquy on H.R. 3043 and S. 1507 among Sens. Jerry Moran, R-Kan., Ron Wyden, D-Ore., and Heidi Heitkamp, D-N.D., 133 *Cong. Rec.* S5686 (Sept. 17, 2014).