

# Anatomy of a State/Tribal Tax Dispute: Legal Formalism, Shifting Incidence, Potatoes, and the Idaho Motor Fuel Tax

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**ABSTRACT:** The law regarding state taxation in Indian country is one of the last bastions of legal formalism in tax law jurisprudence. The ability of a state to tax in Indian country turns on the legal incidence of the tax: in general, a tax on the tribe or tribal members is not allowed; a tax on nonmembers doing business with the tribes or tribal members is allowed. In a world where legal formalism governs and there is no overarching mechanism for reconciling the competing interests of state and tribal governments, state/tribal tax disputes can quickly become contentious. A recent battle between the state of Idaho and the tribes within its borders over fuel tax revenue exemplifies the truculence of state/tribal tax disputes, but also shows that amicable resolution is possible when the courts take small steps away from legal formalism. This article provides an overview of the tax landscape in Indian country and then analyzes the dispute over the Idaho motor fuel tax and what it reveals about resolving state/tribal tax disputes.

**Keywords:** Indian tribes; state taxation; multijurisdictional taxation.

## INTRODUCTION

The law regarding state taxation in Indian country<sup>1</sup> is one of the last bastions of legal formalism in tax law jurisprudence.<sup>2</sup> The ability of a state to tax in Indian country turns on the legal

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<sup>1</sup> This article uses the term "Indian" (as opposed to "Native American") since that is the term used by legal scholars, tribal members, and the law itself (including the Internal Revenue Code). See Newton, N. J. 1995. Memory and misrepresentation: Representing Crazy Horse. 27 *Conn. L. Rev.* 1003, 1003 n.1 (indicating that the term "Indian" is generally used by reservation residents to identify the national group to which they belong); IRC §45A (providing a credit called the "Indian Employment Credit"). Furthermore, this article uses terms such as "Indian country," "Indian lands," "Indian territory," and "reservations" interchangeably to refer to the territory that is under the jurisdiction of a particular Indian tribe. This article also assumes that the boundaries of a tribe's territory are clear. In reality, there could be a threshold issue as to whether a transaction is actually taking place within "Indian country." This issue is beyond the scope of this article. For more detail on the complex definition of Indian country, see Newton, N. J., et al. (editors). 2005. *Cohen's Handbook of Federal Indian Law*, §3.04 (hereinafter *Cohen's Handbook*).

<sup>2</sup> While *U.S. Supreme Court* jurisprudence has been, for the most part, abandoning formalistic doctrines, states and Congress sometimes use formalistic, "bright-line" tests. Legislative formalism, however, is often necessary and salutary. See *infra* note 52.

incidence of the tax.<sup>3</sup> A tax on the tribe or tribal members is generally forbidden. A tax on nonmembers doing business with the tribes or tribal members is generally allowed—even if the economic incidence of the tax falls on the tribe or tribal members. Other areas of tax jurisprudence, such as the rules regarding when states can impose a tax on interstate commerce, have long abandoned such a formalistic approach.

Since formalism is the norm in Indian country, and there is no overriding system in place to reconcile overlapping state and tribal claims to tax revenue, state/tribal tax disputes can quickly become contentious. A recent battle between the state of Idaho and the tribes within its borders over fuel tax revenue exemplifies the truculence of state/tribal tax disputes, but also shows that amicable resolution is possible when the courts take small steps away from legal formalism. The purpose of this article is to analyze the conflict over the Idaho motor fuel tax and what it reveals about resolving tax disputes in Indian country.

This article is organized in three main parts. The first part provides needed background information on Indian tribes in general, their legal status, and an overview of federal, tribal, and state taxation in Indian country. The second part then analyzes the recent motor fuel tax dispute in Idaho and the litigation and state and tribal maneuvering that it spawned. The third part concludes by suggesting what the Idaho motor fuel tax conflict reveals about resolving tax disputes in Indian country.

## AN OVERVIEW OF TAX ISSUES IN INDIAN COUNTRY

To understand the context of the Idaho fuel tax controversy, this part provides an overview of Indian tribes and the complex tax issues that can arise in Indian country.<sup>4</sup>

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### Overview of American Indian Tribes

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#### *The Legal Status of Indian Tribes*

American Indian tribes occupy a unique position in American law. Along with the federal government and the state governments, Indian tribes are considered sovereign entities, in that they have inherent power to govern.<sup>5</sup> In fact, tribes, collectively, are sometimes called the “first

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<sup>3</sup> The “incidence” of a tax refers to the “party on whom the burden of a tax falls” (see Westin, R. 2000. *WG&L Tax Dictionary*, 345). Policymakers normally distinguish the “legal incidence” of a tax from the “economic incidence” of a tax. The legal incidence of a tax falls on the party that is required, by the tax statute, to actually pay the tax to the state. The economic incidence refers to the party(ies) that actually bear the burden of the tax. For example, the legal incidence of the federal corporate income tax falls on the corporation itself (see IRC §11), while the economic incidence may fall on the corporation’s workers, shareholders, vendors, and/or suppliers—depending on the ability of the corporation to pass on the cost of the tax to those parties. While legal incidence is a function of the taxing statute, economic incidence is a function of contractual arrangements and market realities.

<sup>4</sup> For more detail on this background information, see Cowan, M. J. 2007. Tax issues in Indian country: A guide for practitioners. 106 *Journal of Taxation* 296 (providing a basic introduction to tax issues in Indian country); Cowan, M. J. 2005. 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 (hereinafter Cowan, *Double Taxation*) (analyzing the background of state/tribal tax conflicts and proposing a federal solution); Cowan, M. J. 2004. Leaving money on the table(s): An examination of federal income tax policy towards Indian tribes. 6 *Fla. Tax Rev.* 345 (hereinafter Cowan, *Leaving Money*) (reviewing the federal tax treatment of the commercial income of tribes and comparing such treatment to the federal taxation of commercial income earned by state governments).

<sup>5</sup> Canby, W. C., Jr. 2009. *American Indian Law*, 76 (5th edition).

sovereign,”<sup>6</sup> since tribal sovereignty existed prior to the arrival of Europeans in what is now the United States.<sup>7</sup> Today, tribes continue to enjoy a certain degree of sovereignty, but such sovereignty is subject to control by the federal government.<sup>8</sup> Tribes, while governmental entities, are not considered “states” or “foreign nations” for most purposes of the law.<sup>9</sup> Consequently, the systems that have developed to reconcile multijurisdictional claims to taxation in the multistate and international arenas, like the Uniform Division of Income for Tax Purposes Act and the general tax treaties between the U.S. and other countries, do not apply in Indian country.<sup>10</sup>

Under the Indian Commerce Clause of the U.S. Constitution, the federal government has exclusive power over Indian tribes.<sup>11</sup> States, therefore, may only exercise authority on tribal lands within their borders if federal law so provides.<sup>12</sup>

There are 564 federally recognized tribes in the United States, each with their own culture, traditions, history, government, and economic status.<sup>13</sup>

### **Federal Policy and Tribal Economies**

The goals of federal policy towards Indian tribes have varied over the years,<sup>14</sup> but current federal Indian policy emphasizes tribal self-government and self-determination.<sup>15</sup> The idea is that tribes should, to the extent possible, run their own affairs and become less dependent on help from the federal government. If Indian tribes are to be truly self-sufficient, they must develop sophisticated governments with steady revenue streams that can fund needed services. Realistically, this can only occur with economic development by and/or for the tribes.<sup>16</sup>

<sup>6</sup> E.g., Moppett, S. A. (Forthcoming). Acknowledging America’s first sovereign: Incorporating tribal justice systems into the legal research and writing curriculum. *Okla. City U. L. Rev.* (available at SSRN: <http://ssrn.com/abstract=1474457>) (indicating that law students often perceive the American legal system as encompassing only state and federal laws and advocating that law schools incorporate more tribal legal issues into the curriculum to address this misperception).

<sup>7</sup> When the Europeans first arrived in America, “the tribes were sovereign by nature and necessity; they conducted their own affairs and depended upon no outside source of power to legitimize their acts of government.” Canby, *supra* note 5, at 76. Indeed, the European powers implicitly acknowledged tribal sovereignty by dealing with the tribes as they would other foreign governments and by leaving the tribes to govern their own internal affairs. *Id.*

<sup>8</sup> *Id.* at 100-01.

<sup>9</sup> *Cherokee Nation v. Georgia*, 30 U.S. 1, 19 (1831).

<sup>10</sup> See the section “State/Tribal Tax Interaction” below for more on how the multistate and international tax systems address claims by multiple taxing jurisdictions to the same tax base.

<sup>11</sup> Under the Indian Commerce Clause, one of Congress’s enumerated powers is to “regulate Commerce ... with the Indian Tribes.” U.S. Const. art. I, §8, cl. 3. The U.S. Supreme Court has interpreted this clause as vesting exclusive power over the Indian tribes in the federal government. See *Cherokee Nation*, 30 U.S. at 19.

<sup>12</sup> The Founders decided to keep states out of Indian affairs to protect the tribes and to prevent states from triggering wars with the tribes—wars that the new federal government could not afford. See Canby, *supra* note 5, at 13. The relationship between the federal government and the tribes is unique, “marked by peculiar and cardinal distinctions which exist no where else” (*Cherokee Nation*, 30 U.S. at 16). Perhaps the best expression of the special legal status of Indian tribes was Justice Marshall’s description of tribes as “domestic dependent nations” (*Id.* at 17). Tribes are domestic in that they are part of the United States, dependent in that they are subject to federal control, and nations in that they retain a degree of inherent sovereignty. *Cohen’s Handbook*, *supra* note 1, at 1.

<sup>13</sup> See U.S. Department of the Interior, Indian Affairs, Services Overview, at: <http://www.bia.gov/WhatWeDo/ServiceOverview/index.htm>. This article only addresses tribes that are officially recognized by the federal government. Different rules may apply to tribes that have attained only state (and not federal) recognition. For an overview of the complicated federal recognition process, see *Cohen’s Handbook*, *supra* note 1, at §3.02.

<sup>14</sup> For a history of federal Indian policy, see Canby, *supra* note 5, at 12-34.

<sup>15</sup> *Id.* at 30-34.

<sup>16</sup> See *California v. Cabazon Band of Mission Indians*, 480 U.S. 202, 216 (1987) (where the Court noted the federal government’s “‘overriding goal’ of encouraging tribal self-sufficiency and economic development”) (emphasis added).

Tribes take a variety of approaches to self-government and economic development. Some tribes eschew commercial ventures of their own, relying on non-Indians to come onto the reservation, operate businesses that provide jobs, and pay taxes that fund the tribal government.<sup>17</sup> Other tribes focus on developing commercial operations of their own to provide jobs and provide revenue (via profits) to the tribal treasury.<sup>18</sup> Some tribes combine these two approaches.<sup>19</sup>

For those tribes that choose to start their own businesses, the most obvious example is the operation of tribal casinos.<sup>20</sup> These range from the large, “Las Vegas” style casinos such as the Mohegan Sun (operated by the Mohegan Tribe)<sup>21</sup> and Foxwoods (operated by the Mashantucket Pequot Tribal Nation)<sup>22</sup> in Connecticut to much smaller establishments run by tribes in more remote areas.<sup>23</sup> Tribes engage in many commercial activities beyond gambling, however. Tribes run hotels, timber operations, restaurants, manufacturing plants, industrial parks, smoke shops, professional sports franchises, and (most relevant for present purposes) gas stations.<sup>24</sup> Some tribes have become low-cost locations for outsourcing of corporate functions,<sup>25</sup> or even venues for unpopular industries, such as cement factories.<sup>26</sup> In addition, Indian tribes control approximately 56 million acres of land, some of which contain minerals and other natural resources.<sup>27</sup>

The expansion of business activities on Indian reservations (whether or not related to gaming; whether or not operated by the tribe itself) inevitably leads to more non-Indian individuals

<sup>17</sup> Such tribes are essentially following the economic model used by the states. The Navajo Nation, based on the largest reservation in the United States, generally follows this model. The Navajo Nation collected approximately \$52.5 million in tribal taxes in fiscal 2009. See Office of the Navajo Tax Commission at: <http://www.navajotax.org/>.

<sup>18</sup> Since 1934, federal law has encouraged tribes to establish their own business operations. In that year, Congress passed the Indian Reorganization Act (codified at 25 U.S.C. §§461–479) which was designed to “permit Indian tribes to equip themselves with the devices of modern business organization, through forming themselves into business corporations.” S. Rep. No. 73-1080, at 1 (1934). Strange as it may seem, federal government policy actually encourages socialism on Indian reservations.

<sup>19</sup> For example, one could envision a tribe establishing a shopping mall to create jobs and provide government funding. That same tribe might also decide to impose its own sales tax, raising more government revenue from those purchasing goods at the mall.

<sup>20</sup> Indian gaming is regulated under the Indian Gaming Regulatory Act of 1988 (IGRA, codified at 25 U.S.C. §§2701–2721). The IGRA was enacted after the U.S. Supreme Court ruled that California could not prohibit or regulate gaming taking place on Indian reservations. See *California v. Cabazon Band of Mission Indians* 480 U.S. 202, 222 (1987). The IGRA created the National Indian Gaming Commission to regulate tribal gambling operations. 25 U.S.C. §2704. The IGRA divides Indian gaming into three classes (I, II, and III), with differing levels of federal, state, and tribal regulation. Class III activities, the most lucrative, involve traditional casino games such as blackjack and slot machines. 25 U.S.C. §2703(8). Class III activities are subject to the greatest level of regulation. Before a tribe can operate Class III gaming activities, it must negotiate a Tribal-State compact with the state in which its reservation is located. 25 U.S.C. §2710(d)(1). States must negotiate with the tribes in good faith. 25 U.S.C. §2710(d)(3). States that prohibit all forms of gambling in the state, however, are not required to negotiate a gaming compact with the tribes. 25 U.S.C. §2710(b)(1)(B). Since most states allow at least some limited gambling (e.g., “charity nights”), most states that have reservations within their borders are required to negotiate the terms of a Tribal-State gaming compact. Unsurprisingly, this process has led to the proliferation of Indian casinos. Further discussion of Indian gaming is beyond the scope of this article.

<sup>21</sup> See <http://www.mohegansun.com/>.

<sup>22</sup> See <http://www.foxwoods.com/>.

<sup>23</sup> See, e.g., Useem, J. 2000. The big gamble. *Fortune* (Oct. 2): 222 (describing the modest business generated by the Spokane Indians’ casino in Washington state).

<sup>24</sup> E.g., Ansson, R. J., Jr., and L. Oravetz. 2002. Tribal economic development: What challenges lie ahead for tribal nations as they continue to strive for economic diversity? 11 *Kan. J. L. and Pub. Pol’y* 441, 445 (listing typical tribal business ventures); Tebo, M. G. 2006. Betting on their future. *ABA J.* (May): 33 (discussing the legal issues surrounding the Tulalip Tribe’s new shopping mall in Washington state); <http://www.wnba.com/sun/> (website of the Women’s National Basketball Association team the Connecticut Sun, acquired by the Mohegan Tribe in 2003).

<sup>25</sup> E.g., McGregor, J. 2006. The other Indian outsourcer: Accenture and the Umatilla tribes’ bold plan. *Business Week* (Nov. 6): 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. See *id.*

<sup>27</sup> *Cohen’s Handbook*, *supra* note 1, at §21.01.

and entities doing business in Indian country. The increased commercial activities on reservations thus highlight and complicate tax issues in Indian country, a subject to which we now turn.

### **Federal Taxation**

In general, Indian tribes are not subject to the federal income tax on any activities which they undertake directly<sup>28</sup> or through a federally chartered Indian corporation.<sup>29</sup> The exemption covers income from all tribal undertakings, regardless of whether they are governmental or commercial in nature<sup>30</sup> and regardless of whether such activities are conducted on or off the reservation.<sup>31</sup> Activities a tribe conducts via a state-chartered corporation, however, are subject to the federal income tax.<sup>32</sup> The broad exemption from the federal income tax enjoyed by Indian tribes is the product of longstanding IRS policy rather than the product of specific provisions of the Internal Revenue Code.<sup>33</sup>

With a few exceptions,<sup>34</sup> individual tribal members *are* subject to the federal income tax like all other citizens of the United States.<sup>35</sup> Non-Indians doing business on Indian reservations are generally subject to federal tax in the same manner as when they operate elsewhere in the United States.<sup>36</sup>

### **Tribal Taxation**

In discussing tribal and state tax issues in Indian country, it is important to distinguish between “members” of the tribe and “nonmembers” of the tribe. An individual Indian is a member

<sup>28</sup> Rev. Rul. 67-284, 1967-2 C.B. 55. Tribes are *not* viewed as tax-exempt entities (e.g., charities exempt under IRC §501) and are *not* viewed as state governmental units (exempt under longstanding IRS policy and/or under IRC §115). Rather, tribes are simply viewed as being beyond the reach of the Internal Revenue Code.

<sup>29</sup> Rev. Rul. 81-295, 1981-2 C.B. 15. Tribes may establish federally chartered corporations under the Indian Reorganization Act of 1934, noted at *supra* note 18.

<sup>30</sup> See Rev. Rul. 81-295, 1981-2 C.B. 15.

<sup>31</sup> Rev. Rul. 94-16, 1994-1 C.B. 19. Given the broadness of the exemption, tribes can often structure their lucrative business ventures, like casinos, to escape the federal income tax. Per the IGRA (see *supra* note 20), however, tribal members must pay the federal income tax on per-capita distributions of casino profits that they receive from the tribe. 25 U.S.C. §2710(b)(3)(D). In fact, such distributions are subject to federal income tax withholding. IRC §3402(r). Such distributions are only allowed pursuant to a formal plan that has been approved by the Secretary of the Interior. 25 U.S.C. §2710(b)(3).

<sup>32</sup> Rev. Rul. 94-16, 1994-1 C.B. 19.

<sup>33</sup> While the Code does not directly address the income taxation of Indian tribes, IRC §7871 does treat tribes as states for certain enumerated purposes. For example, tribes, like states, are eligible to receive tax-deductible charitable contributions and, with certain restrictions, are eligible to issue tax-exempt bonds. IRC §7871(a)(1) and (a)(4). In addition, taxes paid to Indian tribal governments are deductible in the same manner as taxes paid to states under §164.

While there are no definitive rulings on point, the exemption granted to tribes does not appear to be required by the U.S. Constitution. For a detailed discussion of this issue, see Cowan, *Leaving Money*, *supra* note 4, at 383–388. As Indian casinos began to proliferate in the 1990s, Congress considered, but never enacted, proposals to tax casino profits at the tribal level.

<sup>34</sup> The exceptions are relatively narrow, dealing with income from “allotted lands” held in trust for the tribal members by the federal government (see Rev. Rul. 67-284, 1967-2 C.B. 55) and income earned from fishing rights granted by a treaty (see IRC §7873). In addition, certain settlement payments received from the federal government are exempt. The exemptions for settlement payments are not included in the Internal Revenue Code, but are enumerated elsewhere in the U.S. Code on a tribe-by-tribe (and settlement-by-settlement) basis. See, e.g., 25 U.S.C. §589 (exempting certain settlement payments made to members of the Shoshone tribes).

<sup>35</sup> *Squire v. Capoeman*, 351 U.S. 1 (1956). Recall that per-capita distributions of casino profits are subject to taxation. See *supra* note 31.

<sup>36</sup> Businesses operating on Indian reservations, however, may be eligible for certain federal tax incentives, such as an employment tax credit and accelerated depreciation for property used in Indian country. IRC §45A (Indian employment tax credit); IRC §168(j) (accelerated depreciation).



of a tribe if he/she is listed on the membership roll of the tribe controlling the reservation on which he/she resides or does business. All others, including non-Indians *and members of other Indian tribes*, are considered nonmembers.<sup>37</sup>

As sovereign governments, tribes have the power (and the need) to impose taxes on their members and on nonmembers doing business within their jurisdiction.<sup>38</sup> Most tribal tax systems are of relatively recent vintage, having been spurred by increased revenue needs in the wake of the modern federal Indian policy's emphasis on self-government.<sup>39</sup> Because of poor economic conditions on many reservations, tribal taxes tend to be targeted at outsiders and tend to be transaction-based taxes, like severance taxes, sales taxes, hotel occupancy taxes, and (most relevant for present purposes) fuel taxes.<sup>40</sup>

## State Taxation

### ***Allowance of State Taxation in Indian Country***

Recall that the federal government has exclusive authority over Indian tribes. State power in Indian country is, thus, rather limited. In this vein, the U.S. Supreme Court has noted that states are prohibited from taxing tribes and tribal members directly with regard to their on-reservation activities unless such taxation has been allowed by federal law.<sup>41</sup> States may, however, generally tax tribal members and tribes on their off-reservation activities.<sup>42</sup> Absent federal

<sup>37</sup> See, e.g., *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134, 161 (1980) (where the Court noted that Indians from tribes other than the tribe governing the reservation "stand on the same footing as non-Indians resident on the reservation"). For example, an enrolled member of the Navajo Nation conducting business on the Navajo reservation would be considered a member. A member of the Mohegan Tribe, however, doing business on the Navajo reservation would be considered a nonmember. With respect to state or tribal tax matters, the Mohegan Indian would be treated like any other non-Indian doing business on the Navajo reservation.

<sup>38</sup> 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*, 447 U.S. 134 (1980) (upholding a tribal cigarette tax on nonmembers purchasing cigarettes on the reservation). Like most tribal powers, the power to tax may be limited by federal law. See, generally, *Cohen's Handbook*, *supra* note 1, at §8.04. In addition, the ability of tribes to tax nonmember activity on certain *non-Indian* land located within a reservation may be limited. See *id.*; *Atkinson Trading Co. v. Shirley*, 532 U.S. 645 (2001). This issue, which deals in part with the definition of "Indian Country," (see *supra* note 1) is beyond the scope of this article.

<sup>39</sup> See Canby, *supra* note 5, at 305. See *supra* notes 14–16 and accompanying text for a discussion of federal Indian policy.

<sup>40</sup> The Navajo Nation, for example, has one of the most sophisticated tribal tax systems. The Navajos impose, for example, a 5 percent business activities tax on net gains from reservation business operations, an 18-cent per gallon fuel tax, an 8 percent hotel occupancy tax, a 3 percent sales tax, and a 4 percent severance tax. See Navajo Code, title 24, available at Office of the Navajo Tax Commission, at: <http://www.navajotax.org/>.

<sup>41</sup> E.g., *Okla. Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 453 (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*, 447 U.S. 134 (1980) (striking down a state motor vehicle "privilege" tax assessed on tribal members); *Bryan v. Itasca County*, 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 the 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, 165 (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.

<sup>42</sup> See, e.g., *Okla. Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 462–64 (1995) (upholding a state income tax on tribal members who worked for an Indian tribe, but who lived off of the reservation); *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973) (allowing the state of New Mexico to impose a gross receipts tax on a tribal ski resort operated outside of the tribe's reservation). The federal government, if it so chooses, may preempt state taxation of the off-reservation activity of tribes and tribal members.

preemption,<sup>43</sup> a state is allowed to impose nondiscriminatory taxes on nonmembers doing business on Indian reservations located within the state's borders.<sup>44</sup>

### The Use of Legal Formalism

The ability of states to impose taxes in Indian country turns on the legal incidence of the tax. If the legal incidence is on the tribe or tribal members, taxation is prohibited. If the legal incidence is on a nonmember, taxation is generally allowed—even if the *economic* incidence of the tax is ultimately borne by the tribe or tribal members.<sup>45</sup> Using legal incidence as the touchstone of taxation is formalistic, allowing states to effectively tax tribes and tribal members by calibrating their tax statutes to place the legal incidence of a tax on nonmembers, rather than the tribe or tribal members.<sup>46</sup> Such formalism ignores the practical effects of allowing states to tax activity in Indian country.

What makes the U.S. Supreme Court's formalistic approach to state taxation in Indian country so unusual is that the Court has largely abandoned legal formalism in other areas of state taxation. In 1977, for example, the Court abandoned formalistic rules under which the ability of a state to tax interstate commerce turned on the wording of its tax statutes. In *Complete Auto Transit, Inc. v. Brady*,<sup>47</sup> the Court reviewed its history of determining when a tax that applies to

<sup>43</sup> Federal preemption need not be explicit. All that is required is extensive federal regulation of the activity the state is seeking to tax. See, e.g., *Warren Trading Post Co. v. Ariz. 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 preempted by detailed federal regulation of traders doing business in Indian country). The courts apply a "balancing test" to determine the federal, state, and tribal issues at stake when deciding whether federal law has preempted a state tax. See, e.g., *White Mountain Apache Tribe v. Bracker*, 448 U.S. 136 (1980) (ruling that the federal government had heavily regulated nonmember timber activity in Indian country, thus preempting a state tax on timber). The *Bracker* balancing test, however, is not invoked if the tax on the nonmember is imposed outside of the reservation. *Wagnon v. Prairie Band Potawatomi Nation*, 546 U.S. 95 (2005) (where the Court refused to apply the *Bracker* balancing test and upheld a state fuel tax on nonmember distributors that was charged before the fuel was brought on to the reservation). *Wagnon* is discussed further in the section "The Aftermath: Contention Followed by Resolution" below.

<sup>44</sup> E.g., *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134, 156-59 (1980) (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*, 425 U.S. 463, 483 (1976) (also upholding a state cigarette tax on nonmembers purchasing cigarettes on the reservation because the legal incidence of the tax fell upon the nonmember purchasers). A state tax expert looking at these two cases today would find it difficult to reconcile the Court's allowance of state taxing jurisdiction in Indian country with interstate commerce notions of substantial nexus. *Colville* and *Moe* turn on issues of state and tribal sovereignty, with nonmembers assumed to have nexus with the state in which the reservation is located. *Moe* goes so far as to note that states can require on-reservation Indian retailers to act as tax collection agents when selling to nonmembers. *Moe*, 425 U.S. at 483. By contrast, states cannot compel retailers located in *other states* to act as collection agents, at least with respect to sales/use taxes. (Today, this rule comes from the *Quill* case, discussed at *infra* note 52. At the time of *Moe*, this same rule was based on *National Bellas Hess v. Department of Revenue*, 386 U.S. 753 [1967]). There appears to be little connection between the nexus rules that apply in interstate commerce and the rules regarding state taxing authority on reservations. Indeed, the only reference in *Moe* or *Colville* to traditional nexus rules indicates that such rules do not generally impede state tax jurisdiction in Indian country. See *Colville*, 447 U.S. 134, 182 (Rehnquist, J., concurring in part, concurring in the result in part, and dissenting in part). As noted earlier, multistate tax concepts are of little help in addressing tax issues in Indian country. Likewise, it is unlikely that *Moe* or *Colville* could provide much guidance in our current debates over physical or economic nexus in the multistate tax arena.

<sup>45</sup> An exception would be the rare case where the *Bracker* balancing test, which takes into consideration the federal, state, and tribal interests at issue, results in a state tax being preempted. See *supra* note 43.

<sup>46</sup> See *Okla. Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 460 (1995) (noting that "if a State is unable to enforce a tax because the legal incidence of the impost is on Indians or Indian tribes, the State generally is free to amend its law to shift the tax's legal incidence").

<sup>47</sup> 430 U.S. 274 (1977).

interstate commerce would be allowed under the Dormant Commerce Clause.<sup>48</sup> Historically, state taxes on “the privilege of doing interstate business” in the state were not allowed by the Dormant Commerce Clause, but state taxes on the “the privilege of exercising corporate functions within the state” were allowed.<sup>49</sup> The analysis was based on the *wording* of the statute rather than the substance of the actual tax.<sup>50</sup>

Recognizing the need to abandon formalistic rules in favor of a more practical approach, the Court articulated a four-pronged test to determine when a state tax on interstate commerce would pass muster under the Dormant Commerce Clause: the tax must (1) be applied to activity with “substantial nexus” with the state, (2) be “fairly apportioned,” (3) “not discriminate against interstate commerce,” and (4) be “fairly related to the services” the state is providing.<sup>51</sup> *Complete Auto Transit* thus represents a departure from legal formalism towards practical analysis in Dormant Commerce Clause considerations of state taxation—a path which the Court’s approach to state taxation in Indian country has yet to take.<sup>52</sup>

<sup>48</sup> States are limited in their ability to tax interstate commerce by the Commerce Clause of the Constitution. U.S. Const. art. I, §8, cl. 1, 3 (“The Congress shall have Power ... [t]o regulate Commerce ... among the several States.”). The Commerce Clause is “an affirmative grant of power” to Congress to regulate commerce that transcends state lines. *Quill Corp. v. North Dakota*, 504 U.S. 298, 309 (1992). Thus, Congress may pass laws restricting the ability of states to tax interstate commerce. *Id.* at 309, 318. The Supreme Court, however, has interpreted the Commerce Clause as also containing a so-called “negative” or “dormant” component. *Id.* at 309. Under this dormant component, states are restricted in their ability to tax interstate commerce even when Congress has not spoken. See *id.* at 309, 311.

<sup>49</sup> See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 282 (1977). This approach was known as the *Spector* Rule, named after one of the cases to use this approach, *Spector Motor Service v. O’Connor*, 340 U.S. 602 (1951). The rule was largely one of “draftsmanship and phraseology” that was a “triumph of formalism over substance” and which failed to reflect the economic or practical effects of the state tax on interstate commerce. *Complete Auto Transit*, 430 U.S. at 281.

<sup>50</sup> Indeed, the Court was able to cite at least two instances in which a state tax statute was struck down under the *Spector* Rule, redrafted by the legislature to conform with the *Spector* Rule (without any substantive changes), and then allowed to stand. See *id.* at 284–286. The Court cited *Railway Express Agency v. Virginia*, 347 U.S. 359 (1954) (striking down a Virginia tax under the *Spector* Rule), *Railway Express Agency v. Virginia*, 358 U.S. 434 (1959) (upholding the redrafted version of the Virginia tax under the *Spector* Rule), and *Colonial Pipeline Co. v. Traigle*, 421 U.S. 100 (1975) (upholding a redrafted version of a Louisiana tax that had previously been struck down, under the *Spector* Rule, in the Louisiana courts).

<sup>51</sup> *Complete Auto Transit*, 430 U.S. at 279. The *Complete Auto Transit* test was grounded in prior case law and was not actually explained in detail in the case itself. Subsequent decisions of the Court articulate the meaning of each prong of the test. See, e.g., *Commonwealth Edison Co. v. Montana*, 453 U.S. 609 (1981) (analyzing the discrimination and “fairly related” prongs).

<sup>52</sup> This is not to say that the Court has completely abandoned all formalistic tests with regard to state taxation under the Dormant Commerce Clause. The Court, for example, upheld what can be viewed as a formalistic bright-line test under the nexus prong of the *Complete Auto Transit* test—one looking to whether the taxpayer had physical presence in the taxing state. See *Quill v. North Dakota*, 504 U.S. 298, 317 (1992). In *Quill*, the Court noted that while it had rejected formalism in *Complete Auto Transit*, “not all formalism is alike.” *Id.* at 314. In the Court’s view, *Quill*’s bright-line nexus standard provided a safe harbor that fostered certainty (and thus constituted an acceptable use of formalism) while the *Spector* Rule was simply a “trap for the unwary draftsman” without any substance (and thus constituted an unacceptable use of formalism). See *id.* at 314–315.

It is also important to note that *legislatively imposed* (rather than *judicially imposed*) formalistic rules are often desirable. As virtually every major Dormant Commerce Clause case notes, many state tax matters are best left to the states themselves or to Congress, rather than the courts. See, e.g., *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 628 (1981) (indicating that “the appropriate level or rate of taxation is essentially a matter for legislative, not judicial, resolution” because any court-imposed test would not “adequately reflect the numerous and competing economic, geographic, demographic, social, and political considerations that must inform” such a rule); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 280 (1978) (refusing to impose uniform apportionment rules on the states for income tax purposes because any uniform rules should only be established “after due consideration is given to the interests of all affected States”—which is a policy task best handled by Congress rather than the Court). Legislatively imposed rules, although formalistic, are more likely to reflect practical realities in that they result from compromises between states and the business community. In sharp contrast, the use of legal incidence as the touchstone of state taxation in Indian country is like the *Spector* Rule: a judicially imposed rule divorced from practical realities allowing states to attain the results they want merely by the wording of their taxing statutes.



## State/Tribal Tax Interaction

As the rules summarized above make clear, under current Supreme Court jurisprudence, states and tribes often have the ability to tax the same transactions.<sup>53</sup> This overlapping state/tribal taxing jurisdiction may result in double taxation, a circumstance which is generally not tolerated in multistate or international tax law.<sup>54</sup> When it comes to multistate taxation, the Dormant Commerce Clause requires that state taxes on interstate commerce be fairly apportioned.<sup>55</sup> For income taxes, states generally use an apportionment formula to capture their portion of a multistate company's income.<sup>56</sup> For sales taxes, double taxation is avoided because every state with a sales/use tax generally allows a credit for sales/use taxes validly paid to other states.<sup>57</sup> In the international arena, the foreign tax credit and a network of tax treaties with foreign governments help ameliorate double taxation.<sup>58</sup> While approaches to ameliorating double taxation in the multistate and international tax arenas are not always successful, at least there are mechanisms in place to deal with the double tax problem. These approaches are of no help in the unique tax world of Indian tribes.

The possibility of double taxation can have a chilling effect on nonmember investment in Indian country, stifling economic development. Indeed, double taxation is part of what has been dubbed the "Indian differential"—a combination of factors that make reservations much less attractive to investment than non-Indian communities.<sup>59</sup> For example, a nonmember company extracting oil on an Indian reservation may be subject to both state and tribal severance taxes.<sup>60</sup>

<sup>53</sup> Essentially, this reflects the fact that there is a broad, localized government-within-a-government problem that haunts Indian law in general. Two governments—tribal and state—have at times equal jurisdiction over the same territory. The only government with superior power, and the potential to mediate state/tribal disputes, is the federal government.

<sup>54</sup> The interaction of state and tribal tax systems can also lead to problems that create unfair *advantages* for the Indian tribes. These mainly revolve around tribes and tribal members using their exemption from state taxes to (improperly) sell cigarettes to nonmembers free of state tax over the Internet. See, generally, Sirois, J. I. 2003. Remote vendor cigarette sales, tribal sovereignty, and the Jenkins Act: Can I get a remedy? 42 *Duq. L. Rev.* 27 (describing the problem). These issues are beyond the scope of this article.

<sup>55</sup> E.g., *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

<sup>56</sup> Because each state has its own method of apportioning income, double taxation may not be completely eliminated. That is, a business may be taxed on more than 100 percent of its income—a situation which is generally tolerated. See, generally, *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978) (noting that the Court cannot provide complete protection from double taxation, since the prevention of double taxation would require that all states use the same rules for apportioning income).

<sup>57</sup> Hellerstein, J. R., and W. Hellerstein. 2003. *State Taxation* §18.08[1] (3rd edition). Such credits are generally mandated by the Constitution. See *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175 (1995). The result of the credit system is that a taxpayer will end up paying sales/use tax at the higher of the two tax rates at issue.

<sup>58</sup> IRC §901 (the foreign tax credit); Isenbergh, J. 2000. *International Taxation* 12, 118, noting that the U.S. tax system attempts to limit double taxation in the international arena, but that it can sometimes fail to do so given the "inconsistent rules of source in different countries imposing overlapping taxes." Double taxation can also result when jurisdictions apply different taxes or use different tax bases.

The system of treaties used in international taxation somewhat resembles the use of compacts by tribes and states to resolve various jurisdictional conflicts. The use of state/tribal compacts is discussed below.

<sup>59</sup> The term "Indian differential" has been attributed to former Navajo President Petersen Zah. Kurman, M. J. 1994. Indian investment and employment tax incentives: Building a new highway to Indian country for private sector businesses and jobs. 41 *Fed. B. News and J.* 578, 583. Other factors that stifle development in Indian country include lack of infrastructure and the uncertain legal landscape resulting from the complex mix of federal, state, and tribal law.

<sup>60</sup> 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). These taxes, it should be noted, are on top of any royalty that the oil company may be paying to the tribe in exchange for access to the oil. Tribes have been known to negotiate a royalty agreement with a nonmember extractor and later impose a severance tax on the removal of the oil from the tribe's land. See, e.g., *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130, 133 (1982). The Court has upheld the ability of a tribe to use its sovereign power to impose a tax under these circumstances. *Id.* at 159.

If that same company had been operating outside of Indian country, only the state tax would apply. All else being equal, the nonmember company would most likely choose to operate on non-Indian land before exploiting the resources within Indian country.<sup>61</sup> At first glance, double taxation may not seem like a major factor when it comes to investment decisions in Indian country. The economic impact, however, is often very real. One economic analysis noted, for example, that a double severance tax would reduce on-reservation production, leading not only to a reduction in tax revenue, but a reduction in royalties paid to the tribe and a reduction in on-reservation employment opportunities.<sup>62</sup> The economic impact of a double motor fuel tax (the issue here) is less well documented. A double tax, however, would obviously put on-reservation gas stations at a competitive disadvantage compared to off-reservation gas stations.<sup>63</sup> Furthermore, the specter of double taxation would obviously discourage both tribes and nonmembers from opening gas stations on Indian reservations.

One could argue about which government (state or tribal) is at fault for the presence of double taxation. In reality, both tribes and states need to finance their operations and both (along with the federal government) provide services (roads, schools, a court system, etc.) that benefit nonmembers operating in Indian country. Accordingly, in most cases, both the tribe and the state have valid claims to tax revenue from activity taking place on Indian reservations. Implicitly acknowledging this, the Supreme Court has largely refused to prioritize one government's assertion of tax jurisdiction over the other's, often allowing both the state tax and tribal tax to stand.<sup>64</sup> The absence of a jurisprudential resolution to the competing (and often meritorious) tribal and state claims to taxation stokes historic enmity between tribes and states and can lead to rather contentious state/tribal tax disputes.<sup>65</sup>

Absent a revision in the Supreme Court's views on state/tribal tax matters, there are two primary ways that state/tribal tax conflicts could effectively be resolved: congressional intervention or the use of state/tribal compacts. Congress could use its plenary power over the tribes<sup>66</sup> and its power over state taxes that implicate interstate commerce<sup>67</sup> to develop a scheme to reconcile tribal and state claims to taxation of nonmembers in Indian country. To date, however, Congress has shown little interest in doing so.<sup>68</sup> Even if Congress had the desire to deal with this issue, it is unlikely it would be able to develop one set of rules that would fairly reconcile

<sup>61</sup> This assumes, of course, that the tribe does not have a monopoly on the land containing the natural resources.

<sup>62</sup> Alexander, R. W. 1997. The collision of tribal natural resource development and state taxation: An economic analysis. 27 *N.M. L. Rev.* 387, 416.

<sup>63</sup> This assumes, of course, that there are off-reservation gas stations that are convenient and that the motorists traveling through the reservation are aware of the difference in taxes. Local motorists would likely be aware of the difference in tax. Motorists traveling from outside of the area (those passing through the area or traveling to the reservation to patronize a tribal casino) may be less aware of any tax difference.

<sup>64</sup> See the cases listed in *supra* notes 38 (allowing tribal taxes) and 44 (allowing state taxes). Tribes have argued that state taxes should yield to tribal taxes if the state taxes impinge on tribal sovereignty by disrupting the ability of tribes to self-govern. See, e.g., *White Mountain Apache Tribe v. Bracker*, 448 U.S. 136, 138 (1980). The Court has relegated such concerns to the background. See *id.* at 148 (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.*, 411 U.S. 164, 172 (1973) (noting that "the trend has been away from the idea of inherent Indian sovereignty as a bar to state jurisdiction").

<sup>65</sup> A prime example of a state/tribal dispute is the battle over the motor fuel tax in Idaho, discussed in the section "The Idaho Fuel Tax Dispute" below.

<sup>66</sup> See *supra* note 11 and accompanying text.

<sup>67</sup> See *supra* note 48.

<sup>68</sup> Indeed, Congress is even reluctant to resolve multistate tax issues. Congress will normally only interfere in state tax matters if an important constituency is complaining and there is little opposition. See, e.g., Moore, K. L. 1997. State and local taxation: When will Congress intervene? 23 *J. Legis.* 171, 172. For further discussion, see Cowan, *Double Taxation*, *supra* note 4, at 147-148.

competing state and tribal claims to tax revenue in every case. Each state/tribe relationship is unique—with the state providing some services and the tribe providing others. In some cases, the tribe may be providing significant services on the reservation and should have first claim to the tax revenue. In other cases, the state may be providing significant services in Indian country and should have first claim to the tax revenue. Given the diversity of state/tribal relations, a national “one size fits all” rule is unlikely to yield satisfactory results in all cases.

As an alternative to congressional action, states and tribes can try to put aside their differences and negotiate tax compacts to avoid double taxation, provide certainty, and allocate tax revenue between the tribal government and the state government. Over 200 state/tribal tax compacts are in existence.<sup>69</sup>

The scope and provisions of tax compacts can vary greatly.<sup>70</sup> Often, however, the tribe will agree to collect a tax on the reservation that equals the state tax charged off the reservation. This will prevent the reservation from becoming a tax haven and also eliminate the specter of double taxation. The state and the tribe will then agree how they will divide the revenue collected via the on-reservation tax.

Compacts are advantageous to both parties and the business community because they provide certainty in an otherwise confusing area of the law. With a compact, the state and the tribe are assured of a predictable revenue stream and the business community is assured that it will not be treated more harshly on the reservation than off it. While compacts provide the best possible solution to state/tribal tax conflicts, it is often difficult—as the discussion of the Idaho motor fuel tax illustrates—to get the states and tribes to put aside their differences and agree to work towards a common solution. Another problem, given the odd legal landscape underlying these disputes, is that one party (normally the state) often has the greater bargaining power. What is needed, then, is something that will bring the tribes and states together and level the playing field.<sup>71</sup>

## THE IDAHO FUEL TAX DISPUTE

This part reviews the Idaho fuel tax dispute and the litigation it spawned. The story of this controversy illustrates not only the contentious nature of state/tribal tax disputes, but also a possible path to resolving such disputes.

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### Lead-Up to the Ninth Circuit Case

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Idaho imposes a 25-cent per gallon motor fuel tax.<sup>72</sup> The revenue from the tax is used to fund highway maintenance and construction.<sup>73</sup> Fuel distributors collect the tax and remit it to the state when making sales to fuel retailers.<sup>74</sup> Some of the federally recognized Indian tribes

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<sup>69</sup> *Cohen's Handbook*, *supra* note 1, at §8.05. Tax matters are hardly the only state/tribal sources of contention, and thus compacts are often used to address other state/tribal disputes, such as concerns over water rights. See Note, Intergovernmental compacts in Native American law: Models for expanded usage. 112 *Harv. L. Rev.* 922, 924 (1999).

<sup>70</sup> For some examples, see *Cohen's Handbook*, *supra* note 1, at §8.05.

<sup>71</sup> The Ninth Circuit's approach to legal incidence, discussed below, is one way to “level the playing field” and encourage the states and tribes to negotiate fair tax compacts. Alternatively, Congress could preempt state taxation in Indian country but suspend such preemption if the states negotiate fair compacts with the tribes in good faith. This would give the tribes more bargaining power than they currently enjoy and perhaps enhance the compact negotiation process. See Cowan, *Double Taxation*, *supra* note 4, at 148–149.

<sup>72</sup> Idaho Code §63-2402 (2).

<sup>73</sup> *Coeur d'Alene Tribe of Idaho v. Hammond*, 384 F.3d 674, 679 (9th Cir. 2004).

<sup>74</sup> Idaho Code §63-2402(1).

located in Idaho—the Coeur d’Alene Tribe, the Nez Perce Tribe, and the Shoshone-Bannock Tribes—own and operate retail gas stations on their reservations.<sup>75</sup> Prior to 2001, fuel distributors collected the fuel tax on sales made to the tribes’ gas stations.<sup>76</sup> The tax raises about \$212 million per year.<sup>77</sup> Of that total, about \$3.5 million is derived from Indian reservations.<sup>78</sup>

A fuel distributor who sold fuel to the Coeur d’Alene Tribe challenged Idaho’s motor fuel tax.<sup>79</sup> In 2001, the Supreme Court of Idaho, relying on the formalistic rules that apply in these situations, ruled that the tax was deficient because the legal incidence fell on the tribe (the retailer) rather than on the distributor of the fuel.<sup>80</sup> Accordingly, the Idaho fuel tax could not be imposed on sales made to Indian tribes in the state.

Two developments came in the wake of the Supreme Court of Idaho’s decision. First, the tribes in Idaho (which were no longer required to pay the state fuel tax) each enacted their own fuel tax and earmarked the revenue from the tax to improve and maintain reservation roads.<sup>81</sup> Had the state tax been upheld, it would have been practically impossible for the tribes to impose their own fuel taxes. This is because such tribal taxes would have applied on top of the state tax, creating double taxation and encouraging customers to purchase cheaper fuel off the reservations (which would only be subject to one tax—the state tax). Essentially, the revenue that was formerly going to the state was now going to the tribes.

Second, Idaho amended its motor fuel tax statute and specifically declared that they were doing so to place the legal incidence of the tax on the distributor, rather than the retailer, with the intention of overturning the ruling of the Supreme Court of Idaho.<sup>82</sup> Given the formalistic rules that govern state taxation in Indian country, the state was attempting to regain its ability to tax fuel sold on reservations by shifting the legal incidence of the tax from the tribal retailers

<sup>75</sup> *Coeur d’Alene Tribe*, 384 F.3d at 679.

<sup>76</sup> See *id.*

<sup>77</sup> Wasson, D. 2007. Idaho reaches fuel tax compacts with Nez Perce, Kootenai tribes. *State Tax Today* (Dec. 4) at 233-13.

<sup>78</sup> Russell, B. Z. 2007. Tribes, state at odds on fuel tax: Deadline heightens ongoing battle. *Knight Ridder Tribune Bus. News* (Apr. 15): 1.

<sup>79</sup> *Goodman Oil Co. of Lewiston v. Idaho State Tax Comm’n*, 28 P.3d 996, 997 (Idaho 2001). The facts of *Goodman Oil* are complicated in that they involve the delivery of fuel to the portion of the tribe’s reservation that was located in Washington. These details are not important for purposes of this article.

<sup>80</sup> *Id.* at 1004. The Supreme Court of Idaho found that the Idaho statute was very similar to the Oklahoma statute in *Okla. Tax Comm’n v. Chickasaw Nation*, 515 U.S. 450, 453 (1995), where the U.S. Supreme Court had found the legal incidence of the tax to fall on the tribal retailer. *Goodman Oil*, 28 P.3d at 1003. The Supreme Court of Idaho also addressed whether a federal law, the Hayden-Cartwright Act, allowed states to impose fuel taxes on Indian tribes. *Id.* at 998-1002. Recall that, even if the legal incidence of a state tax falls on a tribe, the tax is still permissible if authorized by federal law. Idaho argued that the Hayden-Cartwright Act, which allows state fuel taxes to apply on United States military bases “or other reservations,” authorized states to impose fuel taxes on Indian reservations. *Id.* at 998-99. The court ruled that the Hayden-Cartwright Act provided no such authorization. *Id.* at 998.

<sup>81</sup> *Coeur d’Alene Tribe*, 384 F.3d at 680. The tribes could have decided to market their tax exemptions by offering cheaper (untaxed) fuel than that sold by gas stations outside of the reservations’ borders. This could have led to increased business, giving the tribes more profits from their gas station operations. Instead, the tribes decided to use the exemptions to collect additional tax revenue. While the tribes at issue all enacted fuel taxes, the Shoshone-Bannock Tribes’ fuel tax was at a lower rate than the state rate—providing a competitive advantage to the tribes’ gas stations. Miller, J. 2007. Coeur d’Alene tribe signs fuel tax agreement. *Idaho Statesman* (Oct. 17): 6. The other tribes enacted fuel taxes that had the same rate as the state. *Id.*

<sup>82</sup> *Id.*; Idaho Code §63-2402(1) (“A tax is hereby imposed on the distributor who receives motor fuel in this state.”) The statute was also changed from a tax on the “the privilege of using the public highways upon the use or possession for use of gasoline” to a tax on “the receipt of motor fuel in this state” by the distributor. *Coeur d’Alene Tribe*, 384 F.3d at 680; Idaho Code §63-2402(1).



to the non-Indian distributors.<sup>83</sup> Certainly, given the formalistic nature of using legal incidence as the touchstone of taxation, Idaho felt confident that it could once again collect taxes in Indian country by simply changing the wording of its statute. That confidence, as the Ninth Circuit would reveal, turned out to be unfounded.

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### The Ninth Circuit's Critical Look at Legal Incidence

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With the tribes now collecting fuel taxes of their own and the state now reasserting taxing jurisdiction over Indian country via its amended law, the battle lines in the war over the fuel tax revenue were drawn. The tribes in Idaho challenged the amended tax statute, claiming that the legal incidence of the tax still fell, impermissibly, on the tribal retailers. The case culminated in the Ninth Circuit Court of Appeals decision in the *Coeur d'Alene Tribe* case.<sup>84</sup>

In reviewing the question of the legal incidence of the tax, the Ninth Circuit refused to accept Idaho's assertion that the legal incidence was on the distributor, rather than the tribal retailer.<sup>85</sup> The court noted that its job was not to interpret the state legislature's intent (express or implied) regarding legal incidence, but rather to determine the party who bears the legal incidence of a tax by looking to federal law:

The incidence of a state tax on a sovereign Indian nation inescapably is a question of federal law that cannot be conclusively resolved in and of itself by the state legislature's mere statement.<sup>86</sup>

The court noted that to follow legislative intent would be tantamount to granting states the power to tax Indian tribes by designating one party as the "taxpayer" while in reality requiring another party (the tribes) to actually pay the tax.<sup>87</sup> Giving the states such power would allow the states to indirectly "threaten the very existence of the Tribes."<sup>88</sup>

The Ninth Circuit then looked at Idaho's revised motor fuel tax statute in light of federal guidelines regarding incidence. The court noted that the legislature had only made cosmetic changes to the law that, in substance, did not really alter the legal obligations imposed on taxpayers.<sup>89</sup> In essence, the revised statute was the same as the statute that the Supreme Court of Idaho found to impose legal incidence on the tribal retailers.<sup>90</sup>

The court then evaluated the motor fuel tax statute "in light of the state statutory scheme, an assessment of its effects, and the total circumstances germane to its incidence."<sup>91</sup> First, the court took note of Idaho's requirement that the distributor actually include the tax on invoices

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<sup>83</sup> Of course, the substance of the tax did not change by the amendment. The economic incidence of the tax—likely falling on the ultimate consumers of the gasoline—remained undisturbed. Idaho's approach in amending the law echoed that taken by the states that changed the wording (but not the substance) of their tax statutes to effectively tax interstate commerce in the era of the *Spector* Rule. See *supra* notes 49–50 and accompanying text.

<sup>84</sup> *Coeur d'Alene Tribe*, 384 F.3d at 680. The tribes prevailed in district court and the Idaho State Tax Commission appealed to the Ninth Circuit. *Id.* at 680–81. The discussion here focuses on the Ninth Circuit opinion.

<sup>85</sup> *Id.* at 682.

<sup>86</sup> *Id.* at 682–683.

<sup>87</sup> *Id.* at 684.

<sup>88</sup> *Id.*

<sup>89</sup> *Id.* at 685.

<sup>90</sup> *Id.* at 684.

<sup>91</sup> *Id.* at 685.

for sales to retailers.<sup>92</sup> The court interpreted this rule as requiring the distributor to pass the tax on to the retailer.<sup>93</sup>

Second, the Ninth Circuit noted that Idaho law allowed the distributor to keep a portion of the tax collected from the retailer as compensation for acting as an agent of the state in “collecting and remitting” the tax.<sup>94</sup> The court viewed this rule as casting the distributor in the role of tax collector and the tribal retailer in the role of taxpayer.<sup>95</sup>

Third, the court noted that Idaho law allowed distributors a credit for fuel taxes it paid but was unable to collect from the retailer.<sup>96</sup> This could occur, for example, if the distributor purchased 100 gallons of fuel but only sold 70 gallons.<sup>97</sup> In that case, the distributor would be entitled to a credit for the tax on the 30 gallons that were never sold.<sup>98</sup> The state argued that this merely reflected the reality that the *economic* incidence of the fuel tax is passed on to the retailer, and that the ability to tax in Indian country does not turn on economic incidence.<sup>99</sup> The court disagreed and viewed the refund rule as providing a strong indication that the *legal* incidence of the tax was in fact on the tribal retailer rather than the distributor.<sup>100</sup>

Finally, the Ninth Circuit decision noted that the retailers, unlike the distributors, are not allowed a refund for taxes that cannot be passed on to the retailers’ customers and receive no compensation for collecting the tax on behalf of the state.<sup>101</sup> The court concluded that this meant that “the tax buck stops with the Indian tribal retailers.”<sup>102</sup>

Taken together, all of these factors indicated that the legal incidence of the tax, despite the legislature’s pronouncements to the contrary, continued to reside with the Indian tribal retailers.<sup>103</sup> As such, Idaho’s revised motor fuel tax was unlawful as it applied to sales to tribal retailers.<sup>104</sup> The state then petitioned the U.S. Supreme Court for a writ of certiorari, a request that the Court denied.<sup>105</sup>

One could observe that the Ninth Circuit was using something akin to economic incidence analysis to determine legal incidence. Normally, legal incidence is clear, especially if the state unambiguously indicates where the legal incidence resides. In refusing to accept the Idaho legislature’s statement regarding incidence and by looking to federal law, the court injected substantive analysis into an otherwise formalistic test. In doing so, the decision somewhat dimmed what had been a bright-line test and created an atmosphere of uncertainty. It was that atmosphere, however, that may well have finally induced the tribes and the state to come together and resolve their motor fuel tax quarrels.

<sup>92</sup> *Id.* at 686 (reviewing Idaho Admin. Code §35.01.05.150(g)).

<sup>93</sup> *Coeur d’Alene Tribe*, 384 F.3d at 686 n.10.

<sup>94</sup> *Id.* at 686–87 (reviewing Idaho Code §63-2407(4)).

<sup>95</sup> See *Coeur d’Alene Tribe*, 384 F.3d at 687.

<sup>96</sup> *Id.* (reviewing Idaho Code §63-2407(6)).

<sup>97</sup> *Coeur d’Alene Tribe*, 384 F.3d at 687.

<sup>98</sup> *Id.*

<sup>99</sup> See *id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.* at 687–688.

<sup>102</sup> *Id.* at 687.

<sup>103</sup> *Id.* at 688.

<sup>104</sup> *Id.* The court went on to determine whether the Hayden-Cartwright Act authorized the state to tax the tribes, finding that it did not. This issue is not relevant to the discussion in this article. See *supra* note 80.

<sup>105</sup> *Hammond v. Coeur d’Alene Tribe of Idaho*, 543 U.S. 1187 (2005).

## The Aftermath: Contention Followed by Resolution

The state's loss in the Ninth Circuit brought the state to the negotiating table with the tribes in an attempt to divide the motor fuel tax being collected by the tribes. Negotiations dragged on, however, and the tribes and the state were not able to come to an agreement.<sup>106</sup> Meanwhile, the U.S. Supreme Court, in *Wagnon v. Prairie Band Potawatomi Nation*, upheld a Kansas motor fuel tax imposed on non-Indian distributors.<sup>107</sup> The Court seemed to back away from the Ninth Circuit's view of legal incidence by saying that "dispositive language" by the legislature as to which party bears the legal incidence of a tax will be determinative.<sup>108</sup> Based on this standard, the Court agreed that the legal incidence of the Kansas tax fell on the distributors.<sup>109</sup>

In 2007, the Idaho legislature, emboldened by *Wagnon* and impatient with the negotiation process, redrafted its motor fuel tax statute (again) to clarify even further that the legal incidence of the tax was not on the tribes but on the distributors. This time, the law was amended to specifically state that "The legal incidence of the tax imposed under this section is borne by the distributor."<sup>110</sup> In addition, in response to the Ninth Circuit's analysis, the revised law said that the distributor was free to pass on the tax to the retailer, but that the pass-through of the tax would not create a legal liability for the tax on the part of the retailer.<sup>111</sup> An exception to this policy applied with respect to Indian tribes.<sup>112</sup> If the distributor was exempt from the tax by virtue of being a tribe or a tribal member, then the legal incidence of the tax would not be on that distributor and the distributor would be legally required to pass on the tax to the retailer.<sup>113</sup> In turn, if the retailer were exempt as a tribe or tribal member, the retailer would be legally required to pass the tax burden on to its customer.<sup>114</sup> If the customer were exempt as a tribe or tribal member, then the state would refund the fuel tax with respect to that sale.<sup>115</sup> The legislature provided, however, that the motor fuel tax, as amended, would not apply to an Indian reservation if the governor and the tribe had concluded a tax-sharing agreement before December 1, 2007.<sup>116</sup>

<sup>106</sup> The Ninth Circuit issued its *Coeur d'Alene Tribe* opinion in August of 2004. At the next Idaho legislative session, in early 2005, the legislature ordered the governor to negotiate with the tribes. See Wasson, D. 2007. Idaho legislative leaders to extend governor's time to negotiate tribal gas tax. *State Tax Today* (Mar. 1): 41-7. The *Wagnon* decision, issued in December of 2005 (discussed below), and a quick succession of different gubernatorial administrations brought the negotiations to a standstill. Negotiations resumed in earnest when C. L. "Butch" Otter became governor in early 2007.

<sup>107</sup> 546 U.S. 95 (2005).

<sup>108</sup> *Id.* at 102-03.

<sup>109</sup> *Id.* The impact of *Wagnon* on the Ninth Circuit's more substantive analysis of legal incidence in the Idaho fuel tax is unclear, as the Court did not cite the Ninth Circuit's opinion. *Wagnon*, however, does seem to mark a reaffirmation of formalism in dealing with legal incidence. The dissenting opinion in *Wagnon*, however, did perform a more detailed analysis of the Kansas statute at issue. The analysis was quite similar to the analysis that the Ninth Circuit performed on the Idaho statute in *Coeur d'Alene Tribe*. The dissenting opinion questioned the majority's conclusion that the legal incidence of the Kansas tax was on the non-Indian distributors because the statute anticipated that the costs of the tax would be passed on to the Indian retailers. *Wagnon*, 546 U.S. at 119 (Ginsburg, J., dissenting). The dissenting opinion in *Wagnon* suggested a path around the formalism by suggesting that, even if the legal incidence of the tax fell on non-Indian distributors, the tax should be struck down under the *Bracker* balancing test. See *Wagnon*, 546 U.S. at 128 (Ginsburg, J., dissenting). The *Bracker* balancing test is discussed at *supra* note 43.

<sup>110</sup> Idaho Code §63-2402(1). The 2007 revisions in the law remain in the text of the statutes to this day, but are irrelevant now that, as will be described below, the tribes and the state have entered into compacts to resolve their fuel tax disputes.

<sup>111</sup> Idaho Code §63-2402(3). Of course, in reality, the distributor is unlikely to absorb the tax in any event. The distributor will pass on the economic burden of the tax to the retailer whether or not the law requires such a result.

<sup>112</sup> *Id.*

<sup>113</sup> Idaho Code §63-2402(6).

<sup>114</sup> *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> Idaho Code §63-2444.

The revised bill passed the legislature and, despite his professed objections to the deadline, the governor signed it into law.<sup>117</sup>

The state, armed with a clarified statute coupled with a deadline, was trying to force the tribes to come to some sort of treaty-like agreement. Whether the new law would have been upheld was unclear, but what was clear was that the implementation of the law would have triggered yet another round of costly litigation over the legal incidence of the tax.

In response to the state's "deadline" approach, the Shoshone-Bannock Tribes threatened to impose taxes on agricultural products raised on 90,000 acres of land leased from the tribe by non-Indians.<sup>118</sup> The tax would have affected about \$150 million worth of product being raised in the heart of Idaho's potato-producing region.<sup>119</sup> The threatened tax was to be designed to raise an amount to cover the loss of the fuel tax revenue.<sup>120</sup> Obviously, the state and tribal positions and threats of taxation on both sides made the negotiating process more contentious.

The confluence of the legislature's deadline, the tribal threats of agricultural taxation, and the governor's attention to the issue—all spurred by the Ninth Circuit's decision—ultimately brought the parties to the negotiating table. The matter was finally brought to a close when the governor signed agreements with the Coeur d'Alene,<sup>121</sup> Shoshone-Bannock,<sup>122</sup> and Nez Perce tribes.<sup>123</sup> The legislature subsequently ratified the compacts.<sup>124</sup>

Under the fuel tax compacts, the tribes agreed to continue to collect a tribal fuel tax equal to the state's tax. Should the state tax increase in the future, the tribes would increase their taxes by the same amount. This mechanism maintains a level playing field between on-reservation and off-reservation sales of gasoline. While the tribes will retain the revenue they collect from the tribal fuel taxes, they agreed to use the funds to pay for road construction and maintenance. While the state forgoes the revenue from its fuel tax in Indian country, presumably the tribes' commitment to dedicate the tax revenue to roadwork relieves the state of some maintenance work it would otherwise need to pay for.

## CONCLUSION

Idaho's state/tribal fuel tax dispute shows the contentious problems that can be manifested under the current tax rules that apply in Indian country. The resolution of the dispute, however, may constitute a sign of hope. While the Ninth Circuit's decision did, at first, appear to poison the already troubled relationship between the state and the tribes, in the long run it was the court's more nuanced view of legal incidence that ultimately led the parties to an agreement. Had the Ninth Circuit upheld the application of Idaho's fuel tax in Indian country, the state would

<sup>117</sup> See Wasson, D. 2007. Idaho governor approves deadline for tribal fuel tax negotiations. *State Tax Today* (Apr. 12): 71–116.

<sup>118</sup> Wasson, D. 2007. Tribes facing down Idaho lawmakers on fuel tax collection. *State Tax Today* (March 14): 50–3.

<sup>119</sup> *Id.*

<sup>120</sup> *Id.*

<sup>121</sup> Agreement for the Collection and Dissemination of Motor Fuel Taxes Within the Boundaries of the Coeur d'Alene Reservation Between the State of Idaho and the Coeur d'Alene Tribe (Oct. 16, 2007) (on file with author); Wasson, D. 2007. Idaho governor lands first Indian reservation fuel tax collection deal. *State Tax Today* (Oct. 18): 202–9.

<sup>122</sup> Shoshone-Bannock Tribes-State of Idaho Motor Fuels Tax Agreement (Oct. 24, 2007) (on file with author); Wasson, D. 2007. Idaho governor, Shoshone tribe sign fuel tax compact. *State Tax Today* (Oct. 26): 208–15.

<sup>123</sup> Agreement for the Collection and Distribution of Motor Fuels Taxes between the Nez Perce Tribe and the State of Idaho (Nov. 30, 2007) (on file with author); Wasson, *supra* note 77. An agreement was also reached with the Kootenai Tribe, which was not a party to the prior litigation. Kootenai Tribe-State of Idaho Motor Fuels Tax Agreement (Nov. 20, 2007) (on file with author). The Kootenai Tribe had no gas stations on its reservation at the time, but agreed to abide by the fuel tax sharing agreement should it open retail fuel outlets in the future. Wasson, *supra* note 77.

<sup>124</sup> Russell, B. Z. 2008. Tribal fuel tax pacts ratified. *Spokesman Review* (Feb. 22).



have had little incentive to bargain with the tribes to divide the revenue and share the burden of road maintenance. While compacts are the most effective way to resolve state/tribal disputes, the state will have little incentive to negotiate with the tribes if they have full control over where to locate the legal incidence of their taxes.<sup>125</sup> By casting doubt on the ability of states to engage in formalistic maneuvers, *Coeur d'Alene Tribe* may have taken some power away from the states, perhaps (as occurred in Idaho) pushing them closer to the bargaining table with the tribes within their borders.

While the scope of the Ninth Circuit's less formalistic view of legal incidence is uncertain—especially since the Supreme Court seems to have backed away from that view in *Wagnon*<sup>126</sup>—it is that uncertainty that may actually aid the compact process. By making the states less sure of their ability to tax in Indian country and taking a few steps away from legal formalism, the court may have paved the way for fairer and more amicable state/tribal negotiations over tax issues.

*Coeur d'Alene Tribe* does not, by itself, solve the persistent problems that continue to plague taxation in Indian country. With no overriding system in place to reconcile competing claims of taxation between states and tribes, and with the U.S. Supreme Court seemingly clinging to formalism, conflicts like the one over the Idaho fuel tax will persist. *Coeur d'Alene Tribe*'s small movement away from formalism is a welcome development, but stops far short of providing a clear, enduring solution to the tax battles that proliferate in Indian country. Perhaps the best one can hope for is that less formalistic approaches to the law will become more common. Such approaches could facilitate more fruitful negotiations that would yield fair tax-sharing agreements between states and the tribes within their borders.

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<sup>125</sup> This is not to say that tribes would be completely powerless to compel the states to negotiate. First, it is likely that the tribes and the states would have other issues—such as the need to negotiate agreements on water rights—that would color their approach to taxes. Furthermore, certain tribes might be in a position to threaten to tax a major state (non-Indian) industry that would not be able to easily relocate. One could envision, for example, a tribe enacting (or threatening to enact) a high severance tax on mineral extractors operating under long-term contracts on the tribe's reservation. See *supra* note 60.

<sup>126</sup> Indeed, the dissenting opinion in *Wagnon* noted that the Court's reaffirmation of formalism cast a "cloud" over the tribal/state compact process that would diminish "prospects for cooperative efforts to achieve resolution of taxation issues through constructive intergovernmental agreements." *Wagnon v. Prairie Band Potawatomi Nation*, 546 U.S. 95, 130-31 (2005) (Ginsburg, J., dissenting).

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