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UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF WASHINGTON

KING MOUNTAIN TOBACCO COMPANY, INC.; DELBERT WHEELER, SR.; and THE CONFEDERATED TRIBES AND BANDS OF THE YAKAMA INDIAN NATION, Plaintiffs, v. ALCOHOL AND TOBACCO TAX AND TRADE BUREAU; JOHN J. MANFREDA, IN HIS OFFICIAL CAPACITY AS ADMINISTRATOR OF THE ALCOHOL AND TOBACCO TAX AND TRADE BUREAU; UNITED STATES DEPARTMENT OF THE TREASURY; and TIMOTHY GEITHNER, IN HIS OFFICIAL CAPACITY AS THE SECRETARY OF UNITED STATES DEPARTMENT OF THE TREASURY, Defendants.	No. CV-11-3038-RMP PLAINTIFF'S REPLY MEMORANDUM IN SUPPORT OF ITS MOTION FOR SUMMARY JUDGMENT

Plaintiff Confederated Tribes and Bands of the Yakama Nation ("Yakama Nation") respectfully submits the following Reply Memorandum to the United States' Memorandum in Opposition to Plaintiffs' Motion for Partial Summary Judgment.

I. INTRODUCTION & SUMMARY OF THE ARGUMENT

The Plaintiff is entitled to summary judgment in this case for three reasons. First, the Government's opposition is premised on a fundamentally flawed characterization of the federal tobacco tax statutes and regulations. The Government's attempt to twist the clear statutory language to fit within the Government's idea of an "excise tax" fails.

Second, the Government's position relies on the wrong analysis, which is also wholly and radically inconsistent with its own well-established and long-standing revenue rulings and tax administration guidance. Under its own policies and practices, the Government's actions here are improper and unsupported by precedent.

Finally, the Government is wrong when it argues that the tax laws have abrogated the Treaty by implication because it fails to acknowledge the legal standard for abrogation of treaties, and can provide no evidence whatsoever for its conclusion. For each of these three reasons, Plaintiff respectfully requests that the Court find in favor of the Plaintiff that the General Allotment Act precludes the Government's taxation efforts here, and is further prohibited under Article II of the Treaty of 1855.

II. LAW AND ARGUMENT

A. The General Allotment Act exempts King Mountain from liability for payment of federal tobacco tax on tobacco directly derived from the land.

1. The federal "tobacco tax" is imposed on "tobacco," not on manufacturing activity

As a matter of law, the statutes and regulations relevant here impose tax on tobacco. However, the Government repeatedly argues for a plain mischaracterization: that the tobacco tax at issue here is "an excise tax on the activity of manufacturing cigarettes." ECF No. 94 at 3. Bafflingly, the Government asserts that "the tobacco excise tax under 26 U.S.C. § 5701 is not a tax on tobacco, it is a tax on the activity of

manufacturing tobacco products like cigarettes." ECF No. 94 at 6. The Government is wrong.

The statutes and regulations relevant here unequivocally tax tobacco in their various forms: as cigarettes ("any roll of *tobacco* wrapped in paper . . ."), cigars ("[a]ny roll of *tobacco* wrapped in leaf tobacco . . . "), pipe tobacco ("[a]ny *tobacco* which . . . is suitable for use . . . by consumers to be smoked in a pipe"), and smokeless *tobacco* ("[a]ny snuff or chewing *tobacco*"). 27 C.F.R. §§ 40.11.[1]

The federal tobacco tax is imposed on tobacco. *See, e.g.*, 26 U.S.C. § 5701(b) ("On cigarettes . . . there shall be imposed the following taxes . . ."); 27 C.F.R. §40.23 ("Cigarettes are taxed at the following rates . . ."); 27 C.F.R. § 40.25 ("Smokeless tobacco products are taxed at the following rates . . ."); 27 C.F.R. § 40.25a ("Pipe tobacco and roll-your-own tobacco are taxed at the following rates . . .") (emphases added). The regulations then go on to say who is liable for payment of that tobacco tax – and the answer, is the manufacturer—" [t]he manufacturer of tobacco products shall be liable for the *taxes imposed on tobacco products* provided by 26 U.S.C. 5701 . . ." 27 C.F.R. § 40.26 (emphasis added). The Government fails to cite or address any of these regulatory provisions which drives the focus of the analysis related to the tobacco tax at issue in this case. *See* ECF No. 94 at 3, 6, and 8. In short, the tobacco good is taxed, and the manufacturer of the tobacco good is liable to pay. The tax is not on the manufacturing activity.

2. The rule established in* Squire v. Capoeman *governs this case;* Dillon v. United States *is inapplicable and distinguishable.

The tobacco the government attempts to tax here comes directly from lands held in trust for an individual Indian, as the Government admits. *See* ECF No. 95 ¶¶ 6-

[1] It is puzzling that the Government does not quote language from any of its own federal tobacco tax statutes or regulations cited here other than a single brief quotation from 26 U.S.C. 5701(b) and (g). *See* ECF No. 94, p. 3.

8. Therefore, the controlling case is *Squire v. Capoeman*, 351 U.S. 1 (1954), in which the Supreme Court held that income "directly derived" from lands held in trust for an individual Indian are exempt from all federal taxes. *Dillon v. United States*, 792 F.2d 849 (9th Cir. 1986), in which the 9th Circuit created a quantitative inquiry via its statement that the income must be "principally derived" from the land. In this way, *Dillon* invited an inquiry into how much of the income is derived from the land as the threshold inquiry. However, reliance on the *Dillon* rule is inappropriate here, for three reasons.

First, as the Government clarified in response to the Court's questioning at oral argument, the percentage of trust grown tobacco does not matter for purposes of the tax exemption analysis under *Capoeman*. *See* ECF No. 69, pp. 37:18-38:22. This makes sense; *Capoeman* did not mention or apply a percentages-type analysis.

As well, *Dillon* is distinguishable: *Dillon* concerned income from a smoke shop[2] located on Indian trust lands. It is undisputed that King Mountain operates an agricultural and manufacturing business, is not a retail smoke shop, and is harnessing the natural resources of that trust allotment. Thus, *Dillon* is inapplicable.

In fact, the conclusion in *Dillon* was pre-ordained by the decisions of previous courts that no part of the income from the operation of a retail store on trust land is, as a matter of law, "directly derived" from the trust land, much less "principally derived." *See, e.g., Critzer v. United States*, 220 Ct.Cl. 43, 597 F.2d 708, *cert. den.*, 444 U.S. 920 1979 (income from motel, restaurant, gift shop, and building rentals not

[2] The Government cites a myriad of other irrelevant and readily distinguishable cases, in addition to the "smoke shop" cases like *Critzer*, *Hale*, and *Cook*. For example, the Government cites cases in which (a) no trust land was involved (*Keiffer*), (b) tribally-owned, not individually-owned land was involved (*Lac Courte Oreilles*, *Fry*), (c) the land was owned by a third party (*Anderson*), (d) a different tribe with a wholly different treaty was at issue (*Kurtz*, *Farris*), or (e) a tribe argued not a treaty right but general principles of tribal sovereignty unconnected with the GAA or any treaty (*Cabazon Indian Casino)*. None of these cases support the Government here.

"directly derived" from the land); *Hoptowit v. Commissioner*, 78 T.C. 137 (U.S.T.C. 1983) (income from smoke shop and tribal council member salary not "directly derived" from the land); *Hale v. United States*, 579 F.Supp. 646 (E.D.Wash. 1984) (income from smoke shop not "directly derived" from the land).

***3. The Government violates its duty of consistency by relying on* Dillon.**

The Government's reliance on *Dillon* here is not only misplaced, but also violates the Government's "duty of consistency." The Government's *Dillon* approach in this litigation is in direct conflict with the Government's position as reflected in its own published guidance and revenue rulings. When, as here, the Government fails to take a litigation position consistent with its published guidance and revenue rulings, Courts often treat those revenue rulings and other published guidance statements of the Government's tax administration policy "as concessions by the Commissioner [of Internal Revenue] where those rulings are relevant to [the court's] disposition of the case." *Rauenhorst v. Commissioner of Internal Revenue*, 119 T.C. 157, 171 (2002). *See also Derby v. Commissioner of Internal Revenue*, T.C. Memo. 2008-45, 2008 WL 540271 (2008). As a result, in *Rauenhorst*, the tax court did not allow the Government "to argue legal principles . . . against the principles and public guidance articulated in the Commissioner's currently outstanding revenue rulings." 119 T.C. at 170-171.

> While this Court may not be bound by the Commissioner's revenue rulings, and in the appropriate case we could disregard a ruling or rulings as inconsistent with our interpretation of the law, in this case it is respondent who argues against the principles stated in his ruling . . . the Commissioner's revenue ruling has been in existence for nearly 25 years, and it has not been revoked or modified. No doubt taxpayers have referred to that ruling in planning their charitable contributions . . . Under the circumstances of this case, we treat the Commissioner's position in Rev.Rul. 78-197, 1978-1 C.B. 83, as a concession. 119 T.C. at 173 (citations omitted).

Also, "[t]axpayers may generally rely on published revenue rulings in determining the tax treatment of their own transactions, if the facts and circumstances of their transactions are substantially the same as those that prompted the ruling." *Silco, Inc. v. United States*, 779 F.2d 282, 286 (5th Cir. 1986) (*citing* 26 C.F.R. § 601.601(e)).

The Government's published revenue rulings and guidance have in fact continued to embrace *Capoeman*: "The [Internal Revenue] Service follows the *Squire v. Capoeman* test." IRS CCA 201007053, 2010 WL 582227 (IRS CCA, May 7, 2009). The 2009 Chief Counsel Advice came to this conclusion based on revenue rulings from decades before which attempted an analysis of the income from trust lands to arrive at a tax-exempt percentage and a taxable percentage, and then backed away from the percentage-type analysis for which the Government argues here. *C.f.*, Rev.Rul. 58-64, C.B. 1958-1, 12 (1958); Rev.Rul. 62-16, C.B. 7, 1962-1 (1962 IRB LEXIS 140). In the 1958 revenue ruling, the Government had allowed an exemption for income from grazing, but not for income from the sale of cattle grazed on that same land. However, after four years and numerous attempts to make this approach work as a practical matter, the Government abandoned Rev.Rul 58-64 completely:

> Upon further consideration and in view of the difficulties . . . in allocating the portion of livestock sales proceeds attributable to the land and the portion attributable to other factors, such as labor, the use of equipment, and the like, **the determination has been made to treat the *full sums* received as 'derived directly' from the lands** . . . just as in similar circumstances . . . proceeds from the sale of crops grown upon trust allotments are so treated.

Rev.Rul. 62-16, C.B. 7, 1962-1 (1962 IRB LEXIS 140) at 2-3.

The Government recognized that this half-century old about-face remains the Government's position today and applies to this case. *See* Declaration of Adam

Moore at Exhibit A (Counsel for the Government focused the Court during oral argument that it is an "all or nothing" analysis for application of the tax –in line with the rulings that trying to part and parcel out the component parts is not the methodology.) This is a well-grounded approach. After all, it would prove very difficult to apply a percentage-type analysis to the myriad of factual considerations which are involved in any business enterprise, including the tobacco products here. *See*, *e.g.*, Declaration of Jaime Aburto Garcia, (hereafter, "Garcia Dec."), ECF No. 45 (describing the numerous trust-property based factors regarding the King Mountain tobacco and tobacco products—all of which have their own fundamentally important grounding in the totality of the King Mountain tobacco product.) The Government has abandoned an approach that would require answers to questions about the relative importance of seeds, seedlings from trust soil, greenhouses on trust land, mechanical and hand irrigation, use of surfacewater and groundwater, fertilizing, the growing process generally including pruning and topping plants, curing, grading, threshing, blending, electricity, weather, labor, and others.)[3] *See*, *also* Rev.Rul. 67-284, C.B. 55 (1967); Chief Counsel Advice, IRS CCA 201007053, 2010 WL 582227 (May 7, 2009).

Because the Government continues to embrace *Capoeman* in its rulings and application, this Court should not allow the Government and its Tax Division—aware of such rulings like *Rauenhorst* and the revenue rulings, to instead attempt to rely on *Dillon* here in this litigation. The Government's litigation position is squarely at odds with a half century of revenue rulings which have not been revoked or limited by the Government, and have no doubt been justifiably relied upon by many Indian taxpayers

[3] This case presents a potent illustration of the difficulties the Government encountered when it tried to determine what proportion of income from trust lands and what proportion was not. See, e.g., Rev.Rul. 62-12.

in their tax and business planning. The Government's position contradicts its long-standing, clearly reasoned, and publicly-available revenue rulings and guidance. This Court should not allow the Government to justify a litigation position it disavowed long ago.

In putting *Capoeman* into effect, the Government's revenue rulings employ a five-element analysis to make the exemption determination. *Id.* Each of the elements is met here, and all of them have been conceded by the Government: (1) King Mountain's land is held in trust (ECF No. 94, ¶¶ 6-8); (2) as a restricted allotment held for an individual and not a tribe (ECF No. 94, ¶ 6); (3) its ultimate product is directly derived from that land (ECF No. 94, ¶ 8); (4) the GAA displays a Congressional intent to protect Indians (ECF No. 94, at 3-4); and (5) the GAA displays a Congressional intent to provide an exemption from tax (ECF No. 94 at 4). Using the Government's own five-point analysis, the *Capoeman* exemption applies to all of King Mountain's income from sales of its tobacco products, and summary judgment should be issued accordingly.

B. Article II provides an exemption from the taxes at issue here.

1. Article II contains "express exemptive language."

The Plaintiff is also entitled to judgment as a matter of law that Article II provides an exemption from the federal tobacco tax here because the "exclusive use and benefit" language of Article II contains "evidence of the federal government's intent to exempt Indians from taxation." *Ramsey v. United States*, 302 F.3d 1074, 1078 (9th Cir. 2002). The plain meaning of the words "exclusive" ("4. Single, sole. Whole, undivided." Merriam-Webster's Collegiate Dictionary at 404 (10th Ed.)) and "benefit" ("2. Profit or gain." Black's at 150 (7th Ed.)) point to the Government's intent to exempt the Yakama from any taxation of income derived from their lands. Of

course, with such clear evidence of the Government's intent to exempt, "any ambiguities as to whether the exemptive language applies to the tax at issue should be construed in favor of the Indians." *Ramsey*, 302 F.3d at 1079.

In any event, the Government's expansive interpretation of *Ramsey* here is not appropriate, because *Ramsey* only examined Article III, a Treaty provision which is not at issue in this motion for partial summary judgment. 302 F.3d at 1080. *Ramsey* provides no support for the Government's argument regarding Article II.

Hoptowit undermines the Government's Article II argument for three reasons. *Hoptowit* is factually distinguishable from this case, because unlike this case, it involved income from a tribal council member's salary and the rental of land for the operation of a retail smoke shop. As well, though admittedly in *dicta*, the 9th Circuit pointed out that Article II's language referring to lands may provide the evidence of the federal government's intent to exempt the Yakama from taxes on income directly derived from the land, citing *Capoeman*. *Hoptowit*, 709 F.2d 564, 566 (9th Cir. 1983). In the 9th Circuit, the question whether Article II expresses the federal government's intent to exempt income from Yakama lands from federal taxes remains an open one.

2. Abrogation of treaties can only be shown by clear and explicit Congressional expression of intent, and abrogation by implication is highly disfavored.

The Government is wrong when it argues that the Internal Revenue laws have "superseded" the Treaty, merely because the federal tax laws are newer and don't contain an express exception for Indian treaty rights. The Court should lend this argument no credence because it is firmly established that the abrogation of an Indian treaty by implication is not to be lightly imputed to Congress. *Menominee Tribe v. United States*, 391 U.S. 404, 412 (1968). In fact, Congress can only abrogate treaties by clear and explicit expressions of intent to do so. *Minnesota v. Mille Lacs Band of*

Chippewa Indians, 526 U.S. 172, 202 (1999). In this analysis, "[w]hat is essential is clear evidence that Congress actually considered the conflict between its intended action on the one hand and Indian treaty rights on the other, and chose to resolve that conflict by abrogating the treaty." *United States v. Dion*, 476 734, 739-40 (1986). Here, the Government has not made this kind of showing because it cannot do so; Congress has never expressed such intent.

The Government is also wrong when it argues that because federal tax laws are "statutes of general applicability," they automatically subordinate treaties to their terms. However, laws of general applicability do not apply where they would "abrogate rights guaranteed by Indian treaties." *Donovan v. Coeur d'Alene Tribal Farm*, 751 F.2d 1113 (9th Cir. 1985) (*quoting United States v. Farris*, 624 F.2d 890, 893-894 (9th Cir. 1980) (courts "presume that Congress does not intend to abrogate rights guaranteed by Indian treaties when it passes general laws, unless it makes specific reference to Indians."). The Government cannot evade its responsibilities under the Treaty, by whatever "artifice or stratagem." ECF No. 16 at ¶ 4.20.

III. CONCLUSION

The Plaintiff respectfully requests that this Court award summary judgment to it, finding that both the GAA and Article II of the Treaty exempt King Mountain from federal tobacco tax here.

DATED this 19th day of November 2012.

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CERTIFICATE OF SERVICE

I hereby certify that on the 19th day of November 2012, I electronically filed the foregoing document with the Clerk of the Court using the CM/ECF System which will send notification of such filing to the following:

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