

# INDIAN TAX STRATEGIES

## Structuring Tribal Business Deals to Maximize Tax Opportunities

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### ***I. STATE TAX APPLICATION OVERVIEW***

Numerous opportunities exist for tribes to structure business deals to maximize the opportunity to collect tribal taxes and/or create tax incentives to attract tenants and business partners in Indian country. Indian tax law is complex and very fact-specific. The key to success is to have a complete and nuanced understanding of the relevant law and its application to the particular business plans of the tribe. These materials are meant to provide a brief overview of the tax opportunities available to tribes planning economic development.

#### **A. Threshold Issue: Legal Incidence**

The determinative issue in many Indian tax cases is where the legal incidence of a state tax falls. In general, a state may not impose its taxes on an Indian tribe or its members in Indian country.<sup>1</sup> *Oklahoma Tax Commission v. Chickasaw Nation*, 515 U.S. 450, 458-59 (1995). Absent an express Congressional statement to the contrary, if the legal incidence of a state excise tax falls on a tribe or tribal member located within Indian country, the state may not impose its tax. *Id.* at 458-59. Local governments, as political subdivisions of the states, are subject to the same limitations.<sup>2</sup> In general, businesses owned and operated by tribes in their own Indian country will be free of state and local taxes such as business, manufacturing, and sales taxes. This principal of federal Indian

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<sup>1</sup> Throughout these materials, references to tribes generally include references to tribal members, tribal departments, and enterprises of tribal governments whether unincorporated divisions of the tribal government or wholly-owned by the tribe and incorporated under tribal law. Different rules may apply to entities not wholly-owned by the tribe and to tribally-owned entities incorporated under state law.

<sup>2</sup> Throughout these materials, references to restrictions on the state's ability to impose a tax on tribes or individual Indians should be read to include restrictions on political subdivisions of the state.

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law has also been held to bar states from taxing the personal property of tribes and their members in Indian country. See, e.g., *Bryan v. Itasca County*, 426 U.S. 373 (1976), *Moe v. Confederated Salish & Kootenai Tribes*, 425 U.S. 463 (1976), and *Oklahoma Tax Commission v. Sac and Fox Nation*, 508 U.S. 114 (1993).

Conversely, if the legal incidence of a state tax falls on a non-Indian, even in Indian country, the state can generally impose its tax. *Chickasaw Nation*, 515 U.S. at 459. Thus, states can generally tax non-Indian businesses in Indian country, as well as the non-Indian customers of Indian and non-Indian businesses. With few exceptions, even where a business owned and operated by a tribe in its own Indian country will be exempt from state business taxes, courts have consistently ruled that the tribe must collect state sales tax from its non-Indian customers in the absence of a statutory exemption or intergovernmental agreement. See, e.g., *Oklahoma Tax Comm'n v. Citizen Band Potawatomi Indian Tribe of Oklahoma*, 498 U.S. 505 (1991); *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134 (1980); *Moe v. Confederated Salish and Kootenai Tribes of Flathead Reservation*, 425 U.S. 463 (1976).

## **B. Preemption Analysis**

There are two exceptions to the general rule described in the preceding paragraph: 1) if there is an express statement of federal law that explicitly prohibits state taxation; and 2) if the state tax infringes upon the tribal right to self-governance. Under the first exception, the state tax will clearly be preempted. Under the second, courts apply a unique preemption analysis – the “balancing test” to determine whether the combined federal and tribal interests in the activity outweigh the state’s interests. If the balance favors the state, it may impose its tax and may also impose minimal burdens on the tribe or its members to assist the state in collecting the tax. *Id.* However, if the federal and tribal interests outweigh those of the state, the state tax is preempted even where the taxable party is a non-Indian. *New Mexico v. Mescalero Apache Tribe*, 462 U.S. 324, 334, 103 S.Ct. 2378, 2386 (1983).<sup>3</sup>

Preemption cases are extremely fact specific, and it’s important not to generalize the results of a single case as they may be applied to a different fact scenario. Generally speaking, the strongest position a tribe can occupy in a preemption case is one in which the tribe owns facilities and equipment and employs tribal members to create a product or service in that tribe’s Indian country for sale to a customer in the tribe’s Indian country, where the tribe also provides the bulk of the infrastructure, regulation and other governmental services to the operation. Conversely, preemption cases generally go against a tribe where the operation is owned and operated by a non-Indian company selling non-Indian goods to non-Indian customers, regardless of the tribe’s provision of land or governmental services to that business.

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<sup>3</sup> Three Ninth Circuit cases, all of which went against a tribe, illustrate the key factual inquiries the courts will undertake in applying the balancing test. See, *Yavapai-Prescott Indian Tribe v. Scott*, 117 F.3d 1107 (C.A.9 Ariz.,1997); *Gila River Indian Community v. Waddell*, 967 F.2d 1404 (9<sup>th</sup> Cir. 1992); and *Gila River Indian Community v. Waddell*, 91 F.3d 1232 (9<sup>th</sup> Cir. 1996).

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### C. Real Property Taxes

Some special rules apply to the taxation of real property. States lack authority to tax real property held in trust for an Indian tribe or its members. *The Kansas Indians*, 72 U.S. 737 (1867); *The New York Indians*, 72 U.S. 761 (1867); *McCurdy v. United States*, 264 U.S. 484 (1924). Even where the trust land is off-reservation, this rule applies. *Mescalero Apache Tribe*, 411 U.S. 145 (1973). States do, however, have authority to impose *ad valorem* taxes<sup>4</sup> on lands owned in unrestricted fee by tribes or their members where the land was formerly allotted under the General Allotment Act. *County of Yakima v. Confederated Tribes and Bands of the Yakima Nation*, 502 U.S. 251 (1992).<sup>5</sup>

Washington State currently provides exemptions from real property tax for certain fee land owned by tribes. These exemptions exist as a matter of state law only, however, and can be modified by the legislature. The first of these, RCW 35.82.210, exempts tribal housing authorities and intertribal housing authorities from property tax. The second, RCW 84.36.010, exempts all property belonging exclusively to any federally recognized Indian tribe located in the state, if that property is used exclusively for essential government services. Because the statutory definition excludes land used for commercial purposes, tribal fee land leased to non-Indian entities will generally not qualify for these exemptions and will be subject to state property taxes.

Even on tribal trust land, non-Indian lessees may be subject to the state leasehold excise tax (“LET”). Under the Washington State Constitution and federal law, much public land is exempt from state property tax. Some of this publicly held land is leased to non-public entities. Examples include leases of lands and/or improvements in federal and state parks to companies that operate food concessions or hotels; in office buildings for coffee and restaurant services; in airports and marine terminals to airlines and shipping companies; and in natural resource areas for harvest of logs, shellfish and other resources. RCW 82.29A provides for a LET to compensate governmental units for services rendered to such lessees of publicly owned property. Leasehold interests subject to the LET may be in real or personal property.

When a tribe or individual Indian leases trust lands to a private entity not otherwise tax exempt, the state may generally impose the LET. However, numerous exemptions exist. When the tribe’s potential lessees will enjoy an exemption from the

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<sup>4</sup> An *ad valorem* tax is one “imposed on property according to its value.” *FDIC v. County of Orange*, 262 F.3d 1014, 1022 (9th Cir.2001); *see also* Black’s Law Dictionary 51 (6th ed. 1990) (“A tax imposed on the value of property.”). By contrast, an excise tax is one “imposed on the performance of an act.” Black’s Law Dictionary 563 (6th ed.1990).

<sup>5</sup> For fee land allotted under other acts, there is a disagreement among the courts. In the Ninth Circuit, the Court held that the Lummi Indian Nation’s fee patented reservation land was not exempt from *ad valorem* taxes imposed by Washington State, despite the fact that the land was allotted under the Treaty of Point Elliot, not the General Allotment Act. *Lummi Indian Tribe v. Whatcom County*, 5 F.3d 1355 (9<sup>th</sup> Cir. 1993). The Sixth Circuit and Crow Tribal Court have reached the opposite conclusion. *See, e.g., United States v. Michigan*, 106 F.3d 130 (6<sup>th</sup> Cir. 1997); *Pease v. Yellowstone County*, Crow Ct. App., June 24, 1994).

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state LET, this creates opportunities for tribes to attract potential lessees, negotiate above-market rental packages, and/or impose a reduced or matching tribal LET. RCW 82.29A.130 provides a long list of exemptions, many of which are available both within and outside Indian country, along with the following two, available only in Indian country:

(6) All leasehold interests held by enrolled Indians of lands owned or held by any Indian or Indian tribe where the fee ownership of such property is vested in or held in trust by the United States and which are not subleased to other than to a lessee which would qualify pursuant to this chapter, RCW 84.36.451 and 84.40.175.

(7) All leasehold interests in any real property of any Indian or Indian tribe, band, or community that is held in trust by the United States or is subject to a restriction against alienation imposed by the United States: PROVIDED, That this exemption shall apply only where it is determined that contract rent paid is greater than or equal to ninety percent of fair market rental, to be determined by the department of revenue using the same criteria used to establish taxable rent in RCW 82.29A.020(2)(b).

Under RCW 82.29A.130(6), if the entity leasing from the tribe is also a tax exempt entity, that party will be exempt from the LET. “To be exempt from the leasehold excise tax, the property subject to the leasehold interest must be used exclusively for the purposes for which the exemption is granted.” WAC 458-29A-400(1).<sup>6</sup>

While a lessee seeking to reduce its LET payments may typically want to reduce what is treated as taxable rent, lessees on tribal lands have an incentive to ensure that they hit the 90% threshold to enjoy the full exemption from LET available under RCW 82.29A.130(7). Applicable definitions are found in RCW 82.29A.020(2). This section provides for determination by the Department of Revenue whether the 90% threshold has been met when the leasehold interest has not been established through competitive bidding, or negotiated in accordance with statutory requirements regarding the rent payable, or negotiated under circumstances, established by public record, clearly showing that the contract rent was the maximum attainable by the lessor. Thus, a tribe should consider establishing by public record, such as by Tribal Council Resolution, the circumstances under which the leasehold interest was negotiated and that the contract rent was the maximum obtainable.

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<sup>6</sup> But, note that “[w]here a lessee is also a tax-exempt government entity, the tax will apply against a private sublessee, even though no contractual arrangement exists between the sublessee and the public lessor.” WAC 458-29A-500(1). Because RCW 82.29A.130(7) provides that even an otherwise taxable entity will be exempt from the LET for all leasehold interests in tribal trust property where it is determined that contract rent paid is greater than or equal to 90% percent of fair market rental, it may be advantageous to structure the deal so that the lease is between the non-public sublessee and the tribe without an intervening non-tribal public entity.

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## **II. PRACTICAL TIPS TO AVOID THE APPLICATION OF STATE TAXES IN INDIAN COUNTRY**

Tribes and their members have significant incentives to ensure that they and their lessees are exempt from state taxes in Indian country.<sup>7</sup> Avoiding otherwise applicable state taxes may allow tribes and their members to offer products and services at competitive prices, to attract lessees who might otherwise locate elsewhere, to negotiate higher rents on tribal lands, or to impose a tribal tax without subjecting lessees to double taxation. There is a wide range of options to enjoy tax preemption, exemptions and/or reduce the amount of tax due. In Washington State, these include the following:

- To enjoy exemption from state taxes applied to the business itself:
  - The business and personal property should be owned by the tribe or member and located in its Indian country. Care must be taken, where there is a non-Indian investor or manager, that the entity's formation documents do not create an ownership interest in the non-Indian party (if this cannot be avoided, the tribe should ensure that it owns a majority of the entity, recognizing that, even then, tax exemption may only apply to the extent of the tribe's or member's ownership).
  - Goods and services should be delivered to the business in Indian country, contracts should notify contractors and vendors of the business' tax exempt status, and the tribe or member should provide tax exempt certificates to all contractors and vendors.
  - Note that for commercial activities, the state tax on real property will apply unless the operation is located on trust land.
- To enjoy preemption of state excise and sales taxes on sales to non-Indian customers under the balancing test, the tribe should attempt to build the strongest possible set of facts. The tribe will be in the best position to obtain a positive tax ruling or win a balancing test case if:
  - The business is located on trust land or fee land in the tribe's own Indian country;
  - The business is wholly owned and operated by the tribe or its wholly-owned enterprise and is either an unincorporated division of the tribal government, incorporated under tribal law, or is a Section 17 tribal corporation;
  - All equipment and facilities used in the business are owned by the tribe or its wholly-owned enterprise;

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<sup>7</sup> Except when speaking of the right or ability to impose a tribal tax, references to tribes throughout this section also include enterprises formed by tribes and individual tribal members.

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- The business creates value in Indian country by producing a service or product through the application of labor and facilities owned and operated by the tribe. For the creation of products, the activity must result in a product that is new and different as compared to its component ingredients; mere packaging, labeling or arrangement of products produced by another entity generally will not meet the test. The determination whether value is created is a particularly fact specific one, which should be carefully undertaken in light of case law and statutory guidance.
- The business employs a substantial number of tribal members. If this is not possible at the outset, there should be a tribal member hiring preference policy in place and/or a mentorship or similar program designed to increase the employment of tribal members by the business.
- The tribe directly or indirectly provides most governmental services and infrastructure to the business.
- To reduce the state tax burden on potential business partners and tenants in order to create incentives to do business in Indian country and/or create opportunities to collect a tribal tax:
  - Consider having the tribe construct and own improvements that will be used by or leased to the non-Indian entity to avoid state sales tax on construction and materials.
  - Include provisions in contracts and leases which provide that where the non-Indian tenant or business partner is exempt from an otherwise applicable tax by virtue of its location in Indian country or its relationship with the tribe, the tenant will pay any tribal tax in an amount up to the amount of the otherwise applicable tax (consider providing a discounted tribal tax rate as an incentive if appropriate).
  - To insulate the tenant from the state leasehold excise tax to the greatest extent possible, options include:
    - Lease the property to a tribal member;
    - Lease the property to a tax-exempt entity;
    - Lease the property to a lessee for a purpose that would enjoy exemption under RCW 82.29A.130 or 82.29A.132 - .138;
    - For leases to entities that are not tax-exempt or for non-exempt purposes, charge at least 90% of fair market rent;

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- Examine the definition of “leasehold interest” in the statute and WAC 458-29A-100(2)(f) to determine whether the deal can be structured in a manner to avoid application of the tax;
- If a leasehold interest will be created, consider establishing rent through a competitive bidding process or negotiation under circumstances, established by public record, clearly showing that the contract rent was the maximum attainable by the tribe in order to avoid application of the LET;
- If a leasehold interest will be created and the lessee will be subject to the LET because rent is less than 90% of fair market and the rent was not established by a competitive bidding process or negotiation as described in the preceding paragraph, examine the definition of “contract rent” to determine whether the tax liability can be reduced;
- Where the lessee will construct or install improvements, consider structuring the deal so that ownership of those improvements transfers to the tribe upon satisfaction of any lender requirements or at another time prior to lease termination).

Because of the complexity and fact-specific nature of Indian tax law, tribes are well advised to discuss business plans with relevant state and local agencies to determine whether the agency will dispute the tribe’s position on the taxability of its activities. Where possible, tribes should obtain tax rulings confirming tax exemptions and preemptions.

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