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"When asked by an anthropologist what the Indians called America before the white man came, an Indian said simply, 'Ours'"[1]

"[G]*overnment's view of the economy could be summed up in a few short phrases: If it moves, tax it. If it keeps moving, regulate it. And if it stops moving, subsidize it."*[2]

I. INTRODUCTION

Indian tribes are on the move. At least those that have opened casinos. Following decades of abject poverty, the advent and rapid expansion of Indian gaming has finally provided tribes with a viable economic development opportunity.[3] Approximately 201 tribes run 321 gaming facilities that employ over 300,000 people.[4] In 2001, tribal gaming operations generated revenue of

1. Vine Deloria, Jr., quoted in Jason Kalish, Note, *Do the States have an Ace in the Hole or Should the Indians call their Bluff? Tribes Caught in the Power Struggle Between the Federal Government and the States*, 38 Ariz. L. Rev. 1345, 1345 (1996).

2. Ronald Reagan, *Remarks to State Chairpersons of the National White House Conference on Small Business, August 15, 1986*, in Ronald Reagan: The Wisdom and Humor of The Great Communicator 60 (Frederick J. Ryan, Jr. ed., 1995).

3. Obviously, not all Indian tribes have benefited from gaming operations. Some tribes are located in remote areas where the operation of gaming facilities would not be feasible. See William C. Canby, Jr., American Indian Law 282 (3d ed. 1998). Other tribes have decided not to engage in such gaming activities for moral reasons. Id. For example, the Navajo Nation, which is based on the largest Indian reservation in the United States (180,000 members living on 27,000 square miles in the southwest), has steadfastly refused to move into gaming out of fear of addiction and a lack of faith in their tribal government. Steve Schmidt, *The Tribe That Won't Play*, San Diego Union-Trib., Oct. 20, 2002, at A1, LEXIS, News Library, SDUT file. The Navajo also avoid gambling because, according to an ancient tribal legend, the tribe was once ruled by an evil "Great Gambler" who vowed to return someday to enslave the tribe. Id. While certain tribes operate high profile casinos (Foxwoods operated by the Mashantucket Pequot Tribe in Ledyard, Connecticut and the Mohegan Sun Casino – the largest casino in the world – operated by the Mohegan Tribe in nearby Uncasville, Connecticut), many tribes operate more modest gaming venues. See e.g., Jerry Useem, *The Big Gamble*, Fortune, Oct. 2, 2000, at 222, 226, 230 (describing, for example, the modest – but sorely needed – business generated by the Spokane Indian's Two Rivers Resort & Casino in Washington State).

4. Nat'l Indian Gaming Ass'n, *Indian Gaming Facts*, at http://indiangaming.org/library/index.html (last visited June 26, 2003) (on file with the author). To put these numbers in perspective, there are currently 562 federally recognized tribes. Id. Therefore, approximately 35% of the tribes are engaged in gaming operations. See id.

$12.7 billion.[5] This income goes untaxed at the tribal level since, for nearly forty years, the Internal Revenue Service ("IRS") has taken the position that the income of Indian tribes is not subject to federal income taxation.

The IRS rulings[6] in this area provide little analysis or support for their conclusions. They appear to be based, however, on the theory that Congress did not designate Indian tribes as taxable entities in the Internal Revenue Code ("IRC") and thus did not intend for them to be taxed.[7] Given the activities and financial status of Indian tribes at the time of the earliest rulings, the issue of whether Indian tribes could or should be subject to federal income taxation was unimportant. Presumably there was simply not enough tax revenue at stake to warrant the IRS spending time and resources attempting to interpret an ambiguous IRC in light of the vast body of statutes, treaties, case law, and constitutional issues dealing with Indian law.[8] Today, however, with the income

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5. Id. This represents less than 10% of the total revenue generated by the gaming industry as a whole. Id. For a somewhat dated, but more comprehensive report on Indian gaming (including a listing of Indian casinos), see U.S. General Accounting Office, Report to the Chairman, Committee on Ways and Means, House of Representatives, Tax Policy: A Profile of the Indian Gaming Industry, GAO/GGD-97-91 (1997). Based on 1995 financial data, net income from Indian gaming operations ran about 38% of gross revenue. Id. at 3. Assuming *arguendo* that this profit percentage was the same for 2001, the Indian tribes in total would have generated approximately $4.8 billion in net income ($12.7 billion gross income x 38% estimated profit percentage). A detailed review of tribal financial data similar to that performed by the General Accounting Office in its 1997 report would need to be performed to confirm these numbers. Profit percentages can obviously vary greatly by tribe. For example, the Mohegan Sun Casino in Uncasville, CT reported net income from continuing operations of $205.4 million on $786.6 million of revenues for the fiscal year ended September 30, 2001, or a 26% net profit margin. Mohegan Sun, 2001 Annual Report 48 (2002), available at http://www.mohegansun.com/about/pdf/Moh_Sun_AR_Financial.pdf.

6. E.g., Rev. Rul. 67-284, 1967-2 C.B. 55, Rev. Rul. 81-295, 1981-2 C.B. 15; Rev. Rul. 94-16, 1994-1 C.B. 19. See discussion infra Part II.A.

7. See infra Part II.A.

8. The fact that Congress closely regulated Indian affairs and controlled tribal funds may have also been a practical factor behind the IRS finding the tribes to fall outside the IRC. The Department of the Interior, which is responsible for Indian affairs, has also historically taken the position that tribes should not be subject to tax given their control by the federal government. M. Maureen Murphy, Congressional Research Service Memorandum: Constitutionality of Taxing Gambling Income of Indian Tribes, Oct. 10, 1995, reprinted in Kathleen M. Niles, *Commentator Says Tax on Tribal Gaming Would be Unconstitutional*, Tax Notes Today, Nov. 30, 1995, LEXIS, 95 TNT 233-40.

For a rare example of a tribe that did have a significant amount of income prior to the advent of Indian gaming see Bob Drogin, Maine Indians; Poverty Still Grips Newly Rich Tribes, L.A. Times, Sept. 3, 1985, at 1. The article describes how certain Maine tribes were using some $81.5 million in land claim settlements to acquire timber

provided by Indian gaming and the rapid expansion of tribal economic activities, the issue of whether Indian tribes could or should be taxed merits more attention.

Much to the chagrin of the Indian tribes, Congress has been eyeing Indian gaming as a potential source of revenue. On two occasions in the past several years, Congress has proposed subjecting the tribes to federal income tax on their gaming earnings.[9] These proposals, and the continued expansion of Indian gaming, call for a critical look at federal tax policy as it applies to Indian tribes.[10]

This Article addresses whether Indian tribes should be subject to federal income taxation from both a tax policy and Indian policy perspective. Underlying the debate over whether the tribes should be taxed is the tribe's unique relationship to the federal government. Congress's power over the Indian tribes is plenary and there is no provision in the Constitution reserving certain powers to the tribes.[11]

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and blueberry barrens, radio stations, a cement factory, and other commercial ventures – which the tribes were able to operate free of federal income tax.

9. See infra Part IV.

10. Much of the commentary surrounding Indian taxation in general tends to dispose of the federal taxation of tribes in a couple of brief paragraphs—basically concluding, "tribes are not taxed" – before quickly moving on to other, more heavily litigated subjects of the day. See, e.g., Russel Lawrence Barsh, *Issues in Federal, State, and Tribal Taxation of Reservation Wealth: A Survey and Economic Critique*, 54 Wash. L. Rev. 531, 553-54 (1979) (providing only two out of fifty-three pages of analysis on the federal taxation of tribes); Jose J. Monsivais, *The Return of the White Buffalo: Taxation Issues Facing American Indian Tribes Conducting Gambling Enterprises on Tribal Lands*, 20 Am. Indian L. Rev. 399, 401-02 (1995-1996) (providing two paragraphs on the subject before presenting a comprehensive review of individual Indian, federal excise tax, and state tax issues); Scott A. Taylor, *An Introduction and Overview of Taxation and Indian Gaming*, 29 Ariz. St. L.J. 251, 252-53 (1997) (providing two paragraphs on the federal taxation of tribes as part of a survey of tax issues in Indian country).

Only one commentator has provided a detailed analysis of the question of whether the Indian tribes could be subjected to federal income tax, concluding that Congress has the power to do so. Stephanie Dean, *Getting A Piece of the Action: Should the Federal Government Be Able to Tax Native American Gambling Revenue?*, 32 Colum. J.L. & Soc. Probs. 157, 159 (1999). See discussion infra Part IV. Dean's article also briefly suggests a few reasons as to why Indian tribes should be subject to income tax. Id. at 178-85; see also discussion infra Part V. Dean's piece does not, however, address federal tax policy issues and Indian policy issues.

This Article probes the federal taxation of Indian tribes for the first time in detail, in light of increased tribal commercial activity. Furthermore, this Article explores the tax and Indian policy arguments for and against extending the federal income tax to the Indian tribes. Specifically, this Article for the first time comprehensively compares the tax treatment of tribes to that of states.

11. See infra Part IV.

Because there are no constitutional constraints to prevent Congress from taxing Indian tribes,[12] the decision of whether to tax the tribes primarily involves fundamental concerns of fairness and equity. A tribe simultaneously acts as a sovereign government and a business entity.[13] Whether the current tax treatment of tribes is appropriate from a tax policy perspective depends on which of these roles one views as controlling. Viewing a tribe as a business entity and comparing it to other similar business entities that are subject to the federal income tax raises policy concerns (for example, the tax system's impact on fair competition). No such concerns are present, however, when viewing a tribe as a government and comparing it to another subfederal government – i.e., a state – which can, free of federal taxation, operate proprietary business activities in addition to operating a government. Of course, even here we are still left with the issue of whether it is appropriate for subfederal governments in general (both states *and* tribes) to have tax exemptions while private businesses do not.

In order to properly understand and analyze this issue, Part II reviews in detail what little the IRS and Congress have said about the taxation of Indian tribes. Since some of the current and proposed tax rules regarding tribes are based on the federal tax treatment of non-profit, tax-exempt organizations (such as charities), Part II also provides a primer on the federal tax treatment of these entities. Non-profit organizations are generally exempt from tax, but may be subject to federal income taxes on their earnings from commercial ventures that are unrelated to their non-profit mission.

Part III summarizes the complex and often perplexing topic of the federal taxation of the states. States, like tribes, are subfederal governments that escape taxation even as they increasingly engage in such traditional private sector activities as running liquor stores, convention centers, insurance pools, and, of course, gambling in the form of state lotteries. Even though tribes and states are treated differently under the Constitution,[14] the federal tax policy towards the states provides at least some concepts that should be applicable to the federal taxation of tribes. As will be seen, the treatment of states is plagued by fundamental consistency problems. Specifically, states escape taxation on their commercial ventures even though non-profit, tax-exempt organizations are taxed on such ventures.

With this as background, Part IV briefly analyzes whether Indian tribes could be subjected to federal income tax. To facilitate this analysis, this Part examines a 1995 Congressional proposal to tax tribal gaming income and the

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12. See infra Part IV.

13. See, e.g., Rev. Rul. 81-295, 1981-2 C.B. 15.

14. For example, states, unlike tribes, enjoy a level of constitutional immunity from federal taxation that the tribes do not. Also, states have certain protections through the political process, such as representation in Congress, that tribes do not. These limit to some extent the ability of the federal government to tax the states. See infra Part III.A.

reaction to this proposal by the Indian tribes. Part IV also provides an overview of the regulation of Indian gaming, as embodied in the Indian Gaming Regulatory Act ("IGRA"),[15] which is necessary in order to understand the 1995 proposed tax. While Indian tribes posit that there are constitutional constraints which prevent Congress from subjecting them to tax, it is clear that Congress has plenary power over the Indian tribes and is free to pass legislation taxing the Indian tribes.[16]

While it is clear that Congress could tax the tribes, the more important question is whether it is prudent to do so from a tax or Indian policy perspective. Part V analyzes in detail whether tribes should be subject to federal income tax based on principles of tax policy and current federal Indian policy. While there are appealing arguments in favor of taxing the tribes, doing so would put tribes and states on different footings from a tax standpoint. This raises concerns of horizontal equity by treating similarly situated entities in dissimilar ways. In fact, a tribal tax would have the effect of adding more inconsistency to a taxing regime already plagued by horizontal equity problems – namely the inconsistent treatment of state commercial ventures (not taxed) and non-profit commercial ventures (generally subject to tax). It would also frustrate long-standing federal Indian policy favoring the economic independence and sovereignty of the tribes and end Congress's recent movement towards treating Indian tribes as states for many purposes of the tax code.

II. CURRENT FEDERAL INCOME TAXATION OF INDIAN TRIBES: AVOID THE ISSUE AND LOSE THE REVENUE

Perhaps the most exciting thing about the current federal income taxation of Indian tribes is the simplicity: tribes, with one very narrow exception,[17] are not subject to federal income taxation – regardless of the nature or location of their activities. This simple conclusion is rare in fields so complex and baffling as tax law, let alone Indian law. Virtually every other entity that desires tax-exempt status has to navigate through a complex thicket of tax provisions in order to ensure exemption.[18] In contrast, a tribe must satisfy only one requirement to escape tax – the federal government (not merely a state

15. 25 U.S.C. §§ 2701-2721 (2000).

16. While Indian tribes are considered "sovereign," such sovereignty exists at the pleasure of Congress, and Congress can and has interfered with tribal sovereignty on numerous occasions. See infra Part IV.

17. This exception relates to the taxation of certain income earned by tribal colleges. See infra Part II.B.2.

18. For example, see the discussion on non-profit entities desiring tax-exempt status infra at Part II.B.2. See also the discussion on the complexity and confusion surrounding the federal tax treatment of states and state-owned entities infra at Part III.

government) must formally recognize it.[19] While the tax-free status of Indian tribes is clear enough, the rationale and analysis behind it is far from obvious. This Part reviews three of the major revenue rulings[20] in which the IRS has found tribes to be non-taxable, speculates as to the rationale behind the rulings, and explores areas of the IRC in which Congress has directly addressed the treatment of Indian tribes.

A. The Ruling Trinity

The IRS has issued three major rulings on the income tax status of tribes, which are analyzed in detail below. First, however, it is important to understand the general structure of the IRC. Section 1 imposes an income tax on single and married individuals and on estates and trusts.[21] Section 11 imposes an income tax on "every corporation."[22] The definition of a corporation "includes associations, joint-stock companies, and insurance companies."[23] One could argue that tribes are considered "associations" and thus taxable as corporations under section 11.[24] As the rulings discussed below show, however, the IRS has never read the IRC in this manner.[25]

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19. Rev. Rul. 94-16, 1994-1 C.B. 19. The recognition process can be long, complicated, and unpredictable. See, e.g., Canby, supra note, 3 at 3-7; Rick Green & William Weir, *A Single Tribe*, Hartford Courant, June 25, 2002, at A1 (reporting the federal recognition of two historically separate tribes as one integrated tribe). Once a tribe is recognized, however, it is beyond the reach of the federal income tax provisions of the IRC and thus is automatically exempt from the federal income tax. Rev. Rul. 94-16, 1994-1 C.B. 19. The discussion in this Article deals only with tribes that have been formally recognized by the federal government.

20. "A 'revenue ruling' is an official interpretation by the Service which has been published in the Internal Revenue Bulletin." Reg. § 601.201(a)(6) (1967).

21. IRC § 1. All section references in this Article are to the Internal Revenue Code (Title 26 of the U.S. Code) unless otherwise indicated.

22. IRC § 11.

23. IRC § 7701(a)(3). The regulations elaborate a bit more, stating that a corporation includes a business entity incorporated under state, federal, or tribal law. Regs. § 301.7701-2(b).

24. While there is no formal definition of the term "association" in the IRC, it generally refers to a group of persons operating as a corporation, but which has not been formally incorporated. See Hecht v. Malley, 265 U.S. 144, 157 (1924) (defining an association as "a body of persons united without a charter, but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise").

25. The IRC does provide a separate definition for Indian Tribal Governments: "[T]he governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is determined by the Secretary [of the Treasury], after consultation with the Secretary of the Interior, to exercise governmental functions." IRC § 7701(a)(40)(A). This definition, however, is of no help in determining whether Indian tribes could be considered taxable associations under the IRC. Section 7701(a)(40) was not added to the IRC until 1982, as part of the Indian Tribal

1. Revenue Ruling 67-284 – Revenue Ruling 67-284[26] was issued under section 61, which defines gross income broadly as "income from whatever source derived . . . ."[27] This ruling was unusual in that it was based on a general question rather than a specific set of facts.[28] The ruling simply stated that the IRS had been asked "to set forth the general principles applicable to the Federal income tax treatment of income paid to or on behalf of enrolled members of Indian tribes."[29] The ruling dealt both with the taxation of individual Indians and with Indian tribes.

a. Taxation of Individual Indians

Most of Revenue Ruling 67-284 addressed the tax treatment of individual Indians. While a detailed review of the taxation of individual Indians is beyond the scope of this Article, a summary is provided here to dispel the widely held belief that Indians do not pay any income tax.[30] The Supreme Court in 1956 made the general tax status of Indians clear: "We agree with the

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Governmental Tax Status Act. See Pub. L. No. 97-473, § 202, 96 Stat. 2605, 2611, reprinted in 1982 U.S.C.C.A.N. The main provisions of the Indian Tribal Governmental Tax Status Act of 1982 are codified in IRC § 7871. Section 7871 provides that Indian tribal governments are to be treated as states under the IRC for certain enumerated purposes. The definition of Indian tribal governments provided under § 7701(a)(40) thus exists primarily to determine which groups of Indians will qualify for treatment as states for certain purposes under § 7871. A detailed discussion of § 7871 is provided at infra Part II.B. A review of the legislative history behind § 7871 is provided at infra Part V.A.4.

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

27. IRC § 61(a).

28. Normally, a specific fact pattern is set forth because a revenue ruling is supposed to "be directly responsive to and limited in scope by the pivotal facts stated in the revenue ruling." Regs. § 601.601(d)(2)(v)(a). Fact patterns in revenue rulings usually are taken from such sources as taxpayer suggestions, IRS technical advice, or court decisions. Id.

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

30. The belief that individual Indians are exempt from the federal income tax stokes a backlash against Indian gaming in general. See National Indian Gaming Association, *Tribal Gaming Myths and Facts* at http://indiangaming.org/info/pr/myths.shtml (last visited June 26, 2003) (on file with the Author) (listing the belief that Indians pay no taxes as one of the great "myths" of Indian gaming); Jerry Useem, *The Big Gamble*, Fortune, Oct. 2, 2000, at 222, 230 (quoting the manager of a fledgling Spokane Indian casino in Washington: "There's a perception that Indians are getting rich off the casinos; [t]hey feel like we don't pay taxes, we can have casinos, and we get checks from the government."). The fact that individual Indians pay federal income tax becomes important in analyzing whether gaming income should be taxed at the *tribal* level. See discussion infra Part V. For further reading on the taxation of individual Indians, see Rev. Rul. 67-284, 1967-2 C.B. 55; see also Monsivais, supra note 9, at 403-07.

Government that Indians are citizens and that in ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens."[31] This general rule that individual Indians are subject to federal income taxation is subject to a couple of exceptions. First, income derived by an Indian directly from allotted lands held in trust by the federal government is not subject to the federal income tax.[32] This was based on the Supreme Court's interpretation of the General Allotment Act ("GAA") in *Squire v. Capoeman*.[33] The GAA, passed in 1887 and reflecting prevailing federal Indian policy at that time, provided that certain tribal lands were to be allotted to individual Indians but were to be held in trust by the federal government for a period of years.[34] The purpose in doing so was to "protect the Indians' interest and to prepare the Indians to take their place as independent qualified members of the modern body politic."[35] At the end of the trust period, the government was to grant a patent in fee simple to the individual Indian allottees, at which time "restrictions as to sale, incumbrance, or taxation" would be removed.[36] The Supreme Court read this language as manifesting a congressional intent to exempt income derived directly from these trust lands until the allottee received the land in fee simple.[37] While this appears to be a straightforward exemption, numerous interpretive problems have arisen.[38]

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31. Squire v. Capoeman, 351 U.S. 1, 6 (1956).

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

33. 351 U.S. at 8. In *Capoeman*, an Indian couple claimed they were exempt from federal tax on profits from the sale of timber on land that was held in trust for them by the federal government. Id. at 4-5. After noting that Indians are generally subject to the federal income tax, the Court found that the timber sale income was tax-exempt under the GAA. Id. at 10.

34. 25 U.S.C. § 348 (2000).

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

36. 25 U.S.C. § 349 (2000).

37. *Capoeman*, 351 U.S. at 8.

38. The IRS lays out the following five part test to determine whether income is exempt under the GAA:

> (1) The land in question is held in trust by the United States Government; (2) such land is restricted and allotted and is held for an individual noncompetent Indian, and not for a tribe; (3) the income is 'derived directly' from the land; (4) the statute, treaty or other authority involved evinces congressional intent that the allotment be used as a means of protecting the Indian until such time as he becomes competent; and (5) the authority in question contains language indicating clear congressional intent that the land, until conveyed in fee simple to the allottee, is not to be subject to taxation.

Rev. Rul. 67-284, 1967-2 C.B. 55. The income will be taxable if any one of the five tests is not met. Id. The interpretive issues mainly arise over whether the income at issue is "derived directly" from the allotted land. For a summary of the problems in this area, see Monsivais, supra note 10, at 403-07. At least one issue here has been resolved: The income earned from the reinvestment (outside of the allotted land itself)

Second, Indians are exempt from federal income taxes where such treatment is provided by statute or treaty.[39] Revenue Ruling 67-284 did not elaborate further on these exemptions, but one example is section 7873.[40] This provision exempts income derived by an Indian from fishing rights that have been recognized under a treaty.[41] This too seems like a straightforward exemption, but its narrow interpretation by the courts has been subject to criticism.[42]

Thus, an Indian is taxed like any other individual under section 1. Only if the income at issue was earned from allotted lands or from some special activity protected by a treaty or a statute will the tax treatment of individual Indians deviate from the norm.

b. Taxation of Indian Tribes

After dealing with the taxation of individual Indians, Revenue Ruling 67-284 only summarily addressed the taxation of tribes in Part V: "Income tax statutes do not tax Indian tribes. The tribe is not a taxable entity."[43] No analysis was provided to support this conclusion.

One can speculate that the IRS was unwilling to say that a tribe was taxable in the absence of a clear statement by Congress to that effect. In the IRS's view, the IRC does not contain any provisions taxing Indian tribes.[44] This was not actually articulated in Revenue Ruling 67-284 or in the rulings

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of income exempt under the five-part test remains taxable. Rev. Rul. 67-284, 1967-2 C.B. 55.

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

40. IRC § 7873. This is the only special income tax exemption for individual Indians that is actually included in the IRC. Other targeted exemptions for members of enumerated tribes for narrow types of income (such as judgments received for claims against the federal government) are included in Title 25 of the U.S. Code. E.g., 25 U.S.C. § 589 (2000) (exempting certain payments made to members of the Shoshone Tribe out of a judgment settlement fund). These exemptions are numerous, but very narrow and are well beyond the scope of this Article. For a summary of the tribes affected by these miscellaneous exemptions, see James Edward Maule, Gross Income: Overview and Conceptual Aspects, A-193-96 (BNA 501-2d 2001).

41. IRC § 7873.

42. E.g., Erik M. Jensen, *American Indian Law Meets the Internal Revenue Code:* Warbus v. Commissioner, 74 N.D. L. Rev. 691 (1998) (taking issue with the Tax Court's ruling in *Warbus v. Commissioner*, 110 T.C. 279 (1998) that § 7873 does not cover cancellation of debt income realized by an Indian on the foreclosure of his fishing boat).

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

44. Congress and the IRS may not be the only ones ignoring the issue: "An odd thing occurs in the minds of Americans when Indian civilization is mentioned: little or nothing." Creative Quotations from Paula Gunn Allen, at http://www.creativequotations.com/one/1079.htm (last visited June 26, 2003).

reviewed below. In other, unofficial documents, however, the IRS has stated its position that a tribe is neither an individual taxable under section 1, nor an association or corporation taxable under section 11.[45] Thus, tribes, in the IRS's view, fall outside the scope of the federal income tax provisions of the IRC. As this Article will describe in Part III, this same rationale also applies to exempt states from taxation.[46]

2. Revenue Ruling 81-295 – Revenue Ruling 81-295 dealt with the tax treatment of a federally chartered Indian corporation.[47] Unlike Revenue Ruling 67-284, Revenue Ruling 81-295 was based on a specific set of facts.[48] A tribe established a corporation to further its economic development activities as allowed under section 17 of the Indian Reorganization Act of 1934 ("IRA").[49] The stock of the tribal corporation was to be owned by all present and future members of the tribe and was not transferable. The corporation was charged with, *inter alia*, managing the leasing and other uses of tribal lands, granting loans for housing and farming, promoting tourism activities including an annual fair and rodeo, and the operation of a catfish hatchery.[50]

The ruling first reiterated that the tribes themselves are not subject to federal taxation:

> No constitutional or statutory provision expressly exempts Indian tribes from federal income taxation. Generally, however, the political entity embodied in the concept of an Indian tribe has been recognized and no tax liability has been asserted against a tribe with respect to tribal income carried on within the boundaries of the reservation.[51]

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45. E.g., Internal Revenue Service Guide to Indian Taxation Issues (Draft) (1993), *reprinted in* Tax Notes Today, Mar. 3, 1994, LEXIS, 94 TNT 42-19. Other governmental agencies have used the same analysis. E.g., U.S. General Accounting Office, supra note 5, at 24 (citing Senate Committee reports for this same proposition).

46. This IRS developed rationale—that states fall outside the provisions of the IRC—exists despite the presence of IRC § 115, which appears to directly address the taxation of states. See the discussion on this issue in Part III, infra.

47. Rev. Rul. 81-295, 1981-2 C.B. 15.

48. See supra note 28.

49. Rev. Rul. 81-295, 1981-2 C.B. 15. The IRA is codified at 25 U.S.C. § § 461-479 (2000).

50. Rev. Rul. 81-295, 1981-2 C.B. 15.

51. Id. For some unknown reason, the ruling did not cite Rev. Rul. 67-284, which was directly on point. One explanation may be that, as noted in supra Part II.A.1., Rev. Rul. 67-284 only provided the conclusion that tribes are not taxable without any analysis. Instead, Rev. Rul. 81-295 cites as support *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973), holding that New Mexico may assess sales tax on a tribal ski lift located outside of the tribe's reservation. While this was a state sales tax case, the Court did state that the Constitution itself did not automatically prevent the state from taxing

This seems to imply that tribes could be viewed as taxable under the IRC, but that in practice they are not taxed under some sort of an intergovernmental immunity doctrine. This immunity must be administrative, rather than constitutional.[52] Thus, the conclusion remains the same as in Revenue Ruling 67-284, but some additional analysis is added which only serves to create more confusion in this already ambiguous area.

The ruling then stated that the federally chartered tribal corporation would be treated the same as the tribe and therefore not subject to federal income taxation with respect to activities conducted on the tribe's reservation.[53] The ruling based its reasoning on the fact that the tribe could conduct the commercial activities listed directly and escape taxation. The mere fact that the businesses were now being run in corporate solution should make no difference from a tax perspective.[54]

By resting its conclusion on the fact that the tribal corporations are exempt because they would have been exempt outside of the corporate solution, the IRS seems to have contradicted its earlier statement that the tribes are not subject to federal income tax because of the "political entity" embodied in the tribe.[55] It would seem that running a fish hatchery and a rodeo would not be considered part of the tribe's political duties, but rather proprietary/commercial enterprises. If tribes are not automatically tax exempt but are not taxed because they are political entities, it would seem that they could be taxed on their *non-governmental* commercial ventures.[56] Given the facts before it, the IRS seemed to have a clear opportunity to draw a line between proprietary and non-proprietary activities, but declined to do so. Instead, the IRS took the position

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the tribe. *Mescalero*, 411 U.S. at 150. Rather it was up to Congress to determine the extent to which the states could tax the Indian tribes. Id. The IRS has apparently extracted from this case the idea that if Congress could allow the states to tax the tribes, certainly Congress could impose a federal tax on the tribes that would be constitutional. See discussion infra Part IV. A detailed review of the complexities of the state taxation of Indian tribes is beyond the scope of this Article.

52. See *Mescalero*, 411 U.S. at 150 (indicating the tribes enjoy no constitutional protection from taxation). See also the discussion at infra Part IV.

53. Rev. Rul. 81-295, 1981-2 C.B. 15.

54. Id. The ruling quoted *Mescalero* for the proposition that "the question of tax immunity cannot be made to turn on the particular form in which the Tribe chooses to conduct its business." *Mescalero*, 411 U.S. at 157 n. 13. Again, this was meant to refer to state taxes, but the IRS used the concept in ruling on a federal tax matter.

55. See supra note 51.

56. This is the same issue that arises in the federal income taxation of states. See infra Part III for a discussion of whether states can be subject to federal income tax, even though they are "political entities," on their non-governmental commercial activities. As discussed in infra Part III, states generally can be subject to income tax on their commercial activities, but with one exception the IRC has been interpreted as not imposing an income tax on any activities of the states.

that nothing has changed by the incorporation and therefore the tax answer should not change either.[57]

The IRS also relied on a couple of federal court cases which held that the incorporation of certain tribal activities under the IRA did not constitute a waiver of the tribe's sovereign immunity with respect to those activities.[58] Since the incorporation did not change the sovereign immunity status, the IRS felt that the tax status of those activities did not change either.

The IRS's refusal to bifurcate the commercial from the governmental activities of the tribe may be attributed to the cost and difficulty of doing so in relation to the amount of revenue that would be generated. It is doubtful that many of the activities of the tribal corporation listed in the ruling would generate much taxable income.

The ruling can also be understood in light of the purposes of the IRA. In that legislation, Congress made it clear that the purpose was to "permit Indian tribes to equip themselves with the devices of a modern business organization, through forming themselves into business corporations,"[59] thus fostering the economic well being of the tribes. Taxation of what had not been taxed when outside the corporate solution would defeat the purpose of the legislation by making it less lucrative for the tribes to engage in commercial activities. If the tribal corporations were subject to tax, tribes would simply not incorporate – rendering section 17 of the IRA ineffective. In this light, the IRS's stance is more defensible.[60]

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57. Yet outside the realm of Indian tribes, incorporation does in fact carry with it serious tax consequences. An individual who operates a sole proprietorship, for example, will be the taxed on the business profits under IRC § 1. If the individual incorporates the business (e.g., to limit liability or as a prelude to an initial public offering), she will be subject to two layers of tax – the new corporation will pay tax under IRC § 11 and the individual stockholder will then pay tax on any dividends received from the corporation under IRC § 1. The IRS will not waive these rules simply because "nothing has changed." Of course, the individual operating the sole proprietorship in this example, unlike the Indian tribe in Rev. Rul. 81-295, was at least subject to tax to begin with. This example does show, however, that the IRS does not, absent abuse, generally disregard the *form* in which a business is conducted when assessing taxes – yet it did just that in Rev. Rul. 81-295.

58. See Rev. Rul. 81-295, 1981-2 C.B. 15. The ruling cites *Maryland Cas. Co. v. Citizens Nat'l Bank of W. Hollywood*, 361 F.2d 517 (5th Cir. 1966); *Parker Drilling Co. v. Metlakatla Indian Cmty.*, 451 F. Supp. 1127 (D. Alaska 1978). Unfortunately, the issue of sovereign immunity is not as straightforward as the IRS believes. See Canby, supra note 3, at 87-95.

59. Rev. Rul. 81-295, 1981-2 C.B. 15 (quoting S. Rep. No. 1080, 73rd Cong., 2d Sess. 1 (1934)).

60. In addition, another purpose of the IRA was to allow for more tribal self-government, albeit under the close supervision and approval of the Department of the Interior. Canby, supra note 3, at 23-25.

Of course, the IRS could have also held tribes taxable on their commercial activities whether in corporate solution or not. This would have put corporate and non-corporate tribal activities on equal footing from a tax standpoint and thus would not contravene the policy of the IRA. Such a move, however, would have overturned implicit IRS policy in place since the birth of the income tax and explicit IRS policy in place since at least since 1967.[61] Thus, it would be troublesome for the IRS to go back and draw the line between commercial and governmental activities after so many years of administrative practice without Congressional action. Also, since the IRS has never asserted taxation against the tribes, it would seem that Congress would have been aware of this when it passed the IRA and thus assumed that tribes would not be taxed whether or not in corporate solution.[62]

Given all these potential problems and the limited revenue at stake, it is understandable that the IRS would simply decline to change its simple, but largely unexplained position that tribes and tribal corporations are not subject to the federal income tax. Of course, now that a number of tribes are making substantial sums of money from their gaming operations,[63] the IRS decision to avoid the issue is perhaps resulting in a much more substantial amount of lost revenue.

3. Revenue Ruling 94-16 – Revenue Ruling 94-16 summarized the taxation of tribes in slightly more detail and expressly stated that tribal activities both on *and off* the reservation are considered non-taxable.[64] Therefore, the tax exemption follows the tax treatment of the tribe – and is not based on the specific activities (governmental or commercial) engaged in by the tribe. The ruling cited Revenue Ruling 67-284 and stated that tribes are not taxable on any commercial activities conducted on or off the reservation. The ruling then cited Revenue Ruling 81-295 for the proposition that federally chartered tribal corporations share the same tax status as tribes and therefore are not subject to federal income taxation regardless of the location (on or off the reservation) of their activities. Finally, the ruling stated, without analysis, that *state* chartered tribal corporations are subject to federal income taxation: "a corporation organized by an Indian tribe under state law does not share the same tax status

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

62. See Helvering v. Winmill, 305 U.S. 79, 83 (1938) (stating that "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law"). Certain provisions of the IRA, which are beyond the scope of this Article, deal with exemptions from state taxation. Nothing in the IRA itself directly addresses issues of federal taxation. In fact, see *United States v. Anderson*, 625 F.2d 910, 915 (9th Cir. 1980), which held that the provisions of the IRA did not give rise to a federal tax exemption for individual Indians.

63. See, for example, the data provided in supra note 5.

64. Rev. Rul. 94-16, 1994-1 C.B. 19.

as the tribe for federal income tax purposes and is subject to federal income tax on any income earned, regardless of the location of the business activities that produced the income."[65] Thus the IRS established an "all or nothing" approach based on the corporate status of the tribal entity rather than the nature of its activities.

There is no analysis as to why a state tribal corporation was singled out for taxation. It could be that a state chartered corporation is so obviously taxable under section 11 that it would be difficult to justify creating an exemption for state corporations that happen to be owned by tribes. After all, the classic taxable corporation is an entity incorporated under state law, usually Delaware.[66]

While it is hard to justify disparate treatment for state and federally chartered corporations, there is at least one plausible explanation. The IRA authorized the creation of federally chartered, federally approved corporations.[67] It did not speak of state chartered entities. It could be that IRS felt constrained by the IRA from finding federally chartered corporations taxable. It confronted no such constraints when it came to ruling on state chartered corporations.[68]

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65. Id.

66. See, e.g., Roberta Romano, *The State Competition Debate in Corporate Law*, 8 Cardozo L. Rev. 709, 709 (1987) (describing Delaware as "the most successful state in the market for corporate charters").

67. 25 U.S.C. § 477 (2000).

68. It could be that the IRS decided to rule so as to put it in a position of having the least amount of explaining to do. It could have found federally chartered tribal corporations non-taxable to avoid offending the IRA and it could have found state chartered tribal corporations taxable to avoid offending traditional notions of what constitutes a taxable corporation. Another possible theory is that the IRS read the IRA as allowing the Secretary of the Interior to limit the powers of the corporation being created – a potential safeguard that may or may not exist in the creation of state-chartered corporations. See id. Whatever the answer, it does seem the IRS worried about the implications of its finding that state tribal corporations were subject to tax: It chose to apply the provision of Rev. Rul. 94-16 that subjects state-chartered tribal corporations to taxation prospectively. Rev. Rul. 94-16, 1994-1 C.B. 19. Only income earned from on-reservation activities was given prospective treatment. Id. The IRS has the authority to decide which rulings it will apply prospectively and which it will apply retroactively. IRC § 7805(b)(8). The use of this authority here presumably allowed tribes operating on-reservation activities through state-chartered corporations to avoid tax by re-incorporating under the IRA. The IRS may have chosen prospective treatment out of fairness (the law was unclear up until that point) or out of a desire to avoid negative reaction to the ruling by tribes operating through state chartered corporations. It is unclear why the prospective treatment was limited to on-reservation activities of state-chartered corporations. One explanation may be that Rev. Rul. 81-295 only addressed exemptions for on-reservation activities (although it did *not* address the tax status of tribal activities conducted through state chartered corporations) – thus the case for protecting a reliance interest is somewhat weaker for off-reservation activities than for on-reservation activities.

Revenue Rulings 67-284,[69] 81-295,[70] and 94-16,[71] taken together, shed little light on *why* tribes are exempt from the federal income tax. They reflect reluctance on the part of the IRS to interpret the IRC as taxing any activities of Indian tribes or their federally chartered corporations. There was just no need to deal with such ambiguous and politically controversial issues when the revenue at stake was minimal. At least the conclusion seems clear today – Indian tribes fall outside the scope of the federal income tax provisions of the IRC.

B. Tribal Provisions in the IRC

Since Indian tribes are considered to fall outside of the basic income tax provisions of the IRC, it is important to note where they are in fact mentioned explicitly. The most important place is section 7871, which treats Indian tribal governments as states for *certain* purposes of the IRC.[72] Part II.B.1 reviews the general provisions of this section and how it works. Part II.B.2 then reviews the provision of section 7871 that subjects federal Indian tribes to tax on certain activities with respect to tribal colleges.[73] In order to understand this provision – which is the only part of the IRC that specifically subjects tribes to the federal corporate income tax – it is first necessary to explain the basics of the taxation of tax-exempt organizations. Finally, Part II.B.3 provides an introduction to recent regulations that have sought to foreclose the use of Indian tribes as parties to abusive tax shelters.

1. Section 7871: General Provisions – Before reviewing the details of section 7871, it is important to understand what it does *not* do. The presence of section 7871 makes it clear that a tribe will *not* automatically be treated as a state under the IRC except for the purposes *actually enumerated* in section 7871. While section 7871 puts tribes and states on equal footing for most purposes, it is silent regarding the application of the federal income tax to income earned by tribes. States, as will be seen, are exempt from tax under separate IRS rulings (which in part interpret section 115 of the IRC) that go

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

70. Rev. Rul. 81-295, 1981-2 C.B. 15.

71. Rev. Rul. 94-16, 1994-1 C.B. 19.

72. IRC § 7871. Popularly known as the Indian Tribal Governmental Tax Status Act of 1982. The definition of an Indian tribal government is provided in IRC § 7701(a)(40). This definition requires that the tribe exercise governmental functions. See supra note 25. The IRS periodically publishes a list of tribes that exercise governmental functions and thus qualify for treatment as tribal governments under IRC § 7701(a)(40) (and thus reap the benefits of § 7871). E.g., Rev. Proc. 2001-15, 2001-1 C.B 465. Tribes that are unsure of their status may apply for a ruling from the IRS. Regs. § 305.7701-1(a) (1984).

73. IRC § 7871(a)(5).

back to 1935.[74] Section 7871 does not say that a tribe is treated like a state for purposes of the federal income tax in general – i.e., section 7871 does not apply the exemption from federal income taxation enjoyed by states to tribes. Section 7871 therefore does not address, and is not the source of, the exemption from federal income taxes enjoyed by Indian tribes.[75] Rather, tribes and federally chartered tribal corporations are protected from taxation by the rulings cited above.[76] As will be seen, the exemptions for tribes and states are quite similar, but they did not spring from the same rulings and they certainly did not result merely from the enactment of section 7871.[77]

74. As will be seen, the rulings on states employ a similar rationale to the rulings on tribes in that the IRS views states as falling outside the scope of the federal income tax. The exemption for states, however, was developed in separate rulings against a backdrop of unique constitutional limitations and an ambiguous provision in the IRC (§115) that are not germane to an analysis of tribal tax issues. See discussion infra at Part III.

75. The legislative history to § 7871, however, did acknowledge that both states and tribes were generally exempt from the federal income tax – albeit under different authorities – prior to the enactment of § 7871 and stated that § 7871 did nothing to alter the tax exempt status of Indian tribes under existing authority (i.e., Rev. Rul. 67-284). S. Rep. No. 97-646, at 8, 12 (1982), reprinted in 1982 U.S.C.C.A.N. 4580, 4586, 4590. For further discussion see infra Part V.A.4.

76. See supra Part II.A.1-3.

77. Despite this, IRC § 7871 is occasionally cited as *the* source of the tax-free status of tribes. E.g., Ann McCullogh, Indian Tribal Taxation: A Cornerstone of Sovereignty, *in* Native American Sovereignty 179, 185 (John R. Wunder ed., 1996) (stating that "[t]he special significance of [IRC § 7871] was not simply that it gave Indian tribes exemption from federal taxation, but that it did so in a very broad manner"); Monsivais, supra note 10, at 401 (citing § 7871 as the provision exempting the income of Indian tribes from taxation). These references to IRC § 7871 as the fountain of exemption for Indian tribes shows the confusion that is rampant regarding the authority for not taxing Indian tribes. If IRC § 7871, which entered the IRC in 1982, were dispositive of the taxation of tribes, the IRS in Rev. Rul. 94-16 would have referred to it. The IRS, quite properly, did not. It is also clear from the legislative history that § 7871 was not intended to address the federal income taxation of Indian tribes: "The bill does not amend the present income tax treatment of Indian tribal governments specified in Rev. Rul. 67-284 . . . ." S. Rep. No. 97-646, at 12 (1982), *reprinted in* 1982 U.S.C.C.A.N. 4580, 4590. The legislative history is reviewed in further detail in infra Part V.A.4.

While section 7871 is not the source of exemption, it does treat tribes[78] as states for several purposes. For example, charitable gifts to tribes are deductible for income and estate tax purposes;[79] taxes paid to tribes are deductible like state taxes under section 164;[80] and tribal accident and health plans are treated like those of states.[81]

Tribes are also treated as states in two other ways under section 7871 but with the added requirement that the tribes be engaged in an "essential governmental function." First, tribes may issue tax-exempt bonds under section 103, but only if the proceeds are used to fund an essential governmental function.[82] States are not subject to an essential governmental function requirement in issuing their tax-exempt obligations.[83] Second, tribes enjoy exemption from certain enumerated excise taxes, but only where such taxes are associated with a transaction involving an essential governmental function of the tribe.[84] Here again, states are not subject to an essential governmental function requirement in receiving exemption from federal excise taxes. An essential governmental function does not include any "function which is not customarily performed by State and local governments with general taxing

78. Subdivisions of tribes will also be treated like subdivisions of states for purposes of IRC § 7871, but only if the subdivision exercises "substantial governmental functions of the Indian tribal government." IRC § 7871(d). The IRS initially released a list of tribal subdivisions that qualify as subdivisions of states for purposes of IRC § 7871. Rev. Proc. 84-36, 1984-1, C.B. 510. Tribal subdivisions include such entities as local governing councils or districts, housing authorities, and water and sewage committees. Id. A tribal subdivision not on the original list may file a request for a private letter ruling to determine whether it will qualify for the benefits of IRC § 7871. Rev. Proc. 84-37, 1984-1 C.B. 513. In seeking a ruling, the subdivision must show that it has been delegated at least one of the three major sovereign powers of the tribe: the power to tax, the power of eminent domain, or the police power. Id. This would indicate that an entity such as federally chartered tribal corporation engaged only in commercial activities (and which has not been delegated any sovereign powers) would not be considered a subdivision of a tribe and thus would be excluded from the provisions of § 7871. This is in spite of the fact that such entities have been granted the same general exemption from federal income taxes enjoyed by tribes under Rev. Rul. 81-295, 1981-2 C.B. 15.

79. IRC § 7871(a)(1).

80. IRC § 7871(a)(3).

81. IRC § 7871(a)(6).

82. IRC § 7871(a)(4), (c).

83. While there is no explicit essential governmental function requirement that applies to states in this area, tax-exemption for obligations issued by both tribes *and* states is limited by the private activity bond rules in IRC § 141. A discussion of these provisions is beyond the scope of this Article.

84. IRC § 7871(a)(2), (b).

powers."[85] Thus, in these two narrow areas,[86] the tribes are subject to the same treatment as the states so long as they are doing something normally done by the states. These rules are summarized in Table 1.

Table 1: Summary of IRC Section 7871

Tribes are Treated as States	*Tribes are Treated as States Only if Engaged in an "Essential Governmental Function"*
In determining whether a contribution to the tribe is deductible by the donor for income or estate tax purposes	In establishing exemption from certain excise taxes (for example, the tax on special fuels, manufacturers excise taxes, communication excise taxes, and the tax on the use of certain highway vehicles)
In determining whether taxes paid to the tribe are deductible to the payor	In determining whether the tribe can issue bonds that generate tax-exempt interest
In determining the tax status of tribal accident and health plans	
For purposes of taxing the unrelated business income of tribal colleges and universities (see Part II.B.2)	

2. Section 7871: Application of the Unrelated Business Income Tax to Tribes – One final area of section 7871 is quite narrow but merits attention because it is the only provision in the IRC that specifically subjects certain income of Indian tribes to the federal income tax. Indian tribes are treated like states for purposes of section 511(a)(2)(B), which deals with the taxation of

85. IRC § 7871(e).

86. Since IRC § 7871 is not the source of the general tax exemption enjoyed by states, the essential governmental function test does not apply to the income taxation of tribes in general. The test only applies in determining whether the tribe can issue tax-exempt bonds or is exempt from certain enumerated excise taxes. Issues surrounding whether Indian tribes should be taxable on activities that are not related to an essential governmental function are discussed in infra Part V.

state colleges and universities.[87] Before explaining section 511(a)(2)(B), it is important to understand how non-profit corporations are generally treated under the IRC.

Non-profit entities such as charities, private schools, social clubs, etc., must apply for tax-exempt status under section 501(a).[88] Generally, only organizations described in sections 501(c), (d), or 401(a) are eligible to apply for tax-exempt status.[89] Until the IRS approves the organization's tax-exempt status, the entity is technically subject to federal income tax – usually as a corporation or association under section 11. Once an exemption is granted, however, it is usually retroactive to the date of organization.[90]

Even if tax-exemption is granted, the organization may still be subject to the section 11 federal corporate income tax on their "unrelated business taxable income" ("UBTI").[91] (The tax itself is commonly called the unrelated business income tax, or "UBIT"). The concept of UBTI is complex, but it essentially means income, less related deductions, earned from a business "the conduct of which is not substantially related . . . to the exercise or performance [of the organization's] charitable, educational, or other purpose or function" for which exemption was granted in the first place.[92] Tax will be imposed even if all of the profits are used to fund the organization's exempt function activities.[93] Thus, the tax law uses a "source of income" rather than a "destination of income test" in determining whether income is UBTI.[94]

For example, assume an organization's exempt function is to operate a school of performing arts for children. As part of the children's education, they are required to participate in certain public performances. The school charges admission to the performances, thus earning income to help fund the school. Because this income was earned in an activity that contributed to the organization's exempt purpose, the income is not UBTI. The source of the funds was an activity central to the school's exempt purpose.[95] If the same organization were to sell computers and then use the profits to fund its performing arts educational programs, the income would be UBTI. This is because the source of the funds was not rooted in the school's exempt purpose.

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87. IRC § 7871(a)(5).

88. For more on the procedures for obtaining tax-exempt status, see IRS Publication 557, Tax-Exempt Status for Your Organization (2001) available at www.irs.gov (last visited Feb. 24, 2003).

89. IRC § 501(a).

90. IRS Publication 557, supra note 88, at 4.

91. IRC § 511.

92. IRC §§ 513(a), 512.

93. IRC § 513(a).

94. Compare the IRS's treatment of the states (using a destination of income test) at infra Part III.

95. Adapted from Regs. § 1.513-1(d)(4)(i) ex. 1 (as amended in 1983).

The fact that the funds were ultimately used to further the school's educational mission is of no consequence.

UBIT was enacted to address concerns over unfair competition.[96] "The tax-free status of . . . [section 501(c)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes."[97] There is little empirical evidence, however, that unfair competition would be rampant in the absence of UBIT.[98] This has led some commentators to question its efficacy.[99] There is some evidence, however, that UBIT promotes efficiency and accountability.[100]

States are not considered section 501 tax-exempt organizations but rather claim exemption under IRS policy as explained in Part III.[101] States, however, are subject to UBIT with respect to the activities of their colleges and universities.[102] This is the only explicit place in the IRC in which the states are subjected to the federal income tax. The reason for subjecting the UBTI of state colleges and universities to tax was to put them on equal footing with private institutions of higher learning.[103] Such private institutions are already subject to the tax on UBTI by virtue of gaining their tax exemption under section 501.[104] Determining the UBTI of colleges can be rather complex and often involves a

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96. Ellen P. Aprill, *Excluding the Income of State and Local Governments: The Need for Congressional Action*, 26 Ga. L. Rev. 421, 466 (1992). One of the driving forces behind the enactment of UBIT was the business activity of colleges and universities. Before the advent of UBTI, the Third Circuit found a charitable subsidiary of New York University to be exempt from tax. C.F. Mueller Co. v. Commissioner., 190 F.2d 120 (3d Cir. 1951). The subsidiary had acquired the stock of the C.F. Mueller Company, a producer and seller of macaroni. Id. at 121. The profits of the business were used by the subsidiary for the benefit of the New York University School of Law. Id. Congress was outraged and feared that if tax-free treatment of such activity were allowed to continue "all the noodles produced in this country will be produced by corporations held or created by universities." Aprill, supra, at 447 n. 111 (quoting Remarks of Rep. Dingell, *Revenue Revision of 1950: Hearings Before the House Comm. on Ways and Means*, 81st Cong., 2d Sess. 579-580 (1950)).

97. Aprill, supra note 96, at 466 (quoting H.R. Rep. No. 2319, at 36 (1950)).

98. See Aprill, supra note 96, at 467 n. 206 (reviewing the literature criticizing the tax on UBTI).

99. Id.

100. Id. at 468.

101. Certain state owned entities might qualify, however, as exempt organizations under § 501 in addition to being exempt from tax under IRC § 115. Aprill, supra note 96, at 445.

102. IRC § 511(a)(2)(B).

103. Aprill, supra note 96, at 447.

104. It is not clear why Congress was so concerned about putting state institutions on par with private institutions when it has failed to provide such equivalent treatment for other state and § 501 organization businesses. See the discussion of the federal taxation of states in Part III, infra.

certain amount of line drawing between those activities that are related to education and those that are not.[105]

Indian tribes are treated like states when states are treated like section 501 tax-exempt organizations with respect to their colleges and universities.[106] Thus, Indian tribes are subject to the corporate income tax (i.e., UBIT) on any UBTI earned by tribal colleges or universities. This is the only explicit place in the IRC that specifically subjects Indian tribes to the corporate income tax. This is a narrow area to be sure, but may become more important as tribes use their new income streams from gaming to expand tribal education programs.[107]

3. Provisions Shutting Down Indian Tax Shelters – With the exception of UBIT on tribal colleges and universities, it should be abundantly clear by now that tribes are not subject to federal income taxation. While the IRS has recognized this status, it has been vigilant in preventing tribes from taking advantage of their tax-free status to aid in tax shelter transactions.[108] Tribes are in a unique position to act as accommodating parties in transactions among taxpaying entities. The goal of such transactions is to shift the unpleasant tax consequences of a deal on to the Indian tribe, which, since it does not pay taxes, is indifferent to such consequences. The tribe, of course, receives a fee for its part in the deal.

An example of such a shelter that was popular in recent years involved the Indian tribe acting as an intermediary between the seller and the buyer of a business.[109] A seller of an incorporated business with a high stock basis, but low asset basis, would prefer to sell stock rather than assets in order to minimize his

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105. See, e.g., Iowa State Univ. of Science and Tech. v. United States, 500 F.2d 508 (Ct. Cl. 1974) (holding the income from a state college's television station was subject to UBIT); Rev. Rul. 80-296, 1980-2 C.B. 195 (holding that income from the sale of broadcasting rights to athletic events was not subject to UBIT because the games were related to the entity's exempt educational purpose and ticket sales to a live game would have been exempt); Priv. Ltr. Rul. 97-20-035 (Feb. 19, 1997) (holding that income from the use of a state university's golf course by students and faculty was not UBTI but that use by family and alumni was UBTI).

106. IRC § 7871(a)(5).

107. The creation of Indian colleges is a fairly recent development. Most tribal colleges have been in existence less than 25 years. As of February 1999, there were 31 tribal colleges spread across 12 states and serving nearly 25,000 students. American Indian Higher Education Consortium & The Institute for Higher Education Policy, Tribal Colleges An Introduction A2-A3, C1 (1999).

108. Modern corporate tax shelters are currently stimulating much interest. It is often difficult to draw a line between legitimate tax planning and abusive tax shelters. For detailed commentary on this subject, see Symposium, *Corporate Tax Shelters*, 55 Tax L. Rev. 125 et seq. (2002).

109. Peter A. Glicklich & Abraham Leitner, *Loss Importation—Opportunities and Limitations*, Tax Notes Today ,paragraph 41, Feb. 16, 1999, LEXIS, 1999 TNT 30-138.

gain. A buyer, on the other hand, would prefer to buy assets rather than stock in order to take a stepped-up, fair market value basis in the assets. To accomplish both goals, the seller would sell the stock to an Indian tribe. The Indian tribe would then liquidate the corporation and sell the assets of the business to the buyer. Thus, the seller minimized his gain by selling his high basis stock. The buyer received the stepped up basis he desired – along with the resultant increase in depreciation or amortization deductions.

In 1998, the Treasury Department issued regulations under section 337 to shut down this transaction.[110] Under the new regulations, a corporation that transfers assets to a tax-exempt entity (such as upon its liquidation) must recognize any built in gain inherent in its assets as if the assets had been sold for their fair market value immediately before the transfer.[111] A tribe is treated as a "tax exempt entity" for this narrow purpose.[112] While this tax shelter has been shut down, certainly there is the possibility that other shelters may be operating to take advantage of the tax-exempt status of Indian tribes.

C. Summary

Indian tribes and federally charted tribal corporations are not subject to federal income taxes on any of their activities – governmental or proprietary and on or off reservation. This is the result of the IRS's interpretation that tribes are not embraced by the IRC and thus are not subject to income tax. The only exception is that the federal corporate income tax applies to any UBTI of tribal colleges. In addition, state chartered tribal corporations are fully subject to the corporate income tax. Analysis and support for these positions are lacking.

III. FEDERAL TAXATION OF STATES

Given the confusion over the rationale behind the non-taxation of Indian tribes, it is instructive to review the federal taxation of another type of subfederal government – that of the states. Here the record is much more developed, yet still filled with confusion. Like Indian tribes, states have engaged in commercial/non-governmental activities over the years. States engage in such lucrative businesses as lotteries, pension funds, liquor stores, utilities, and hotel

110. Regs. § 1.337(d)-4 (as amended in 1998).

111. Id.

112. Regs. § 1.337(d)-4(c)(2)(iv) (as amended in 1998). Tribes, presumably in an attempt to protect their fee income, complained that treating tribes as "tax exempt entities" for this narrow purpose would be the first step towards subjecting tribes to UBIT on all of the their unrelated activities (not just on the UBTI of tribal colleges) and thus was beyond the rule-making power of the Treasury. See Letter from Hans Walker Jr., Attorney for Mississippi Band of Choctaw Indians, to Commissioner, Internal Revenue Service (April 15, 1997) reprinted in Tax Notes Today, May 22, 1997, LEXIS, 97 TNT 99-29.

and convention centers.[113] As this Part will describe, states, with one exception,[114] are not subject to federal income tax on *any* of their activities – governmental or proprietary. Thus, they are treated similarly to tribes under the IRC. The rationale behind this exemption, however, is based on a constitutional and statutory backdrop that is unique to states.

The federal taxation of states appears deceptively simple. Section 115 appears to be directly on point:

> Gross income does not include – (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.[115]

The presence of section 115 would seem to indicate that states in general are subject to tax but that certain of their income – those generated from essential governmental functions – is exempt. Under this view, a state will not pay taxes on its tax revenue but may be subject to taxes on non-governmental activities – such as the operation of a lottery or a liquor store. While at least one commentator has embraced this view,[116] the interpretation of section 115 and the taxation of states has been much different in practice: "What has emerged behind [section 115's] not unpleasant façade is a Daliesque world in which

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113. E.g., Aprill, supra note 96, at 479-96. For a discussion on state lotteries, see infra Part V.A.2. Whenever tax revenues shrink, states may attempt to make up the shortfall by entering into innovative (and humorous) commercial enterprises. See, e.g., David Brunori, *The Politics of State Taxation: Vinny, Viagra, and Vegas*, State Tax Today, Oct. 21, 2002, LEXIS, 2002 STT 203-12 (reporting a Florida town's plan to pay for new police cars by renting advertising space on the cars for commercial products and facetiously recommending that the town tailor each ad to the particular offense being committed: "If you've got a drunk driver or public drunkenness problem, you would send in the Budweiser police car. If you have a traffic accident, you can send in the Allstate Insurance police car. The possibilities are endless.").

114. This one exception is, of course, the imposition of UBIT on the UBTI of state colleges and universities. IRC § 511 (a)(2)(B). See supra Part II.B.2.

115. IRC § 115. Note that the "essential governmental function" test (discussed infra at Parts III.A. and III.B) applies only to the states and not to possessions of the United States. See id. The reason for sparing possessions from the test is unknown. See Aprill, supra note 96, at 425 n. 10. One commentator has speculated, "[p]erhaps being a possession is itself an essential function in relation to the federal government." Id.

116. See Stefan F. Tucker & Robert A. Rombro, *State Immunity from Federal Taxation: The Need for Reexamination*, 43 Geo. Wash. L. Rev. 501, 512-13 (1975). The conclusions of this article on IRC § 115 were criticized in David M. Richardson, *Federal Income Taxation of States*, 19 Stetson L. Rev. 411, 507-08 (1990).

metamorphosing constitutional doctrine and misshapen statutory analysis can be seen gnawing the cadaver of sound jurisprudential reasoning."[117]

With that ominous preview in mind, this part of the Article attempts to summarize two overlapping doctrines – one constitutional, the other statutory/administrative – that underlie the federal taxation of the states. Before exploring the statutory landscape, it is important to understand to what degree the Constitution insulates the states from federal taxation. Therefore, Part III.A examines the implied immunity of the states from federal taxation under the Constitution. Part III.B then reviews the statutory immunity from the federal income tax that the states enjoy thanks to the IRS's interpretation of the IRC and section 115.

A. Implied Constitutional Immunity

There are two areas of intergovernmental tax immunity under the Constitution. First, there is federal immunity from state taxation. *McCulloch v. Maryland* established that the states may not tax the federal government when it is executing one of its delegated powers.[118] *McCulloch* held that Congress had the power to create a national bank and set up a branch of that bank in Maryland.[119] If Congress has power over something under the Constitution, its power in that area is plenary and thus supreme to that of the states.[120] Thus the states cannot interfere with that exercise of power. It follows that Maryland could not tax the bank because such a tax would interfere with the federal government's exercise of its power: "[T]he power to tax involves the power to destroy."[121] Thus the primary drivers of this immunity are the powers delegated to Congress in the Constitution combined with the Supremacy Clause.

The second area of constitutional immunity, and the focus of this section of the Article, is state immunity from federal taxation. This immunity is not based on a specific clause in the Constitution but rather is implied based on the constitutional nature of the relationship between the federal government and the state governments and the Tenth Amendment.[122] This implied immunity

117. Richardson, supra note 116, at 509.

118. 17 U.S. 316, 436-37 (1819).

119. Id. at 424-25.

120. Id. at 436. See also, U.S. Const. art. VI., cl. 2 ("This Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land . . . any Thing in the Constitution or Laws of any State to the Contrary notwithstanding").

121. *McCulloch*, 17 U.S. at 431.

122. Aprill, supra note 96 at 428 n. 27; Michael Wells & Walter Hellerstein, *The Governmental-Proprietary Distinction in Constitutional Law*, 66 Va. L. Rev. 1073, 1080-85 (1980). The Tenth Amendment provides: "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X.

was first sanctioned in *Collector v. Day*, where the Court held that the federal government could not tax the salary of a Massachusetts judge.[123] While the federal government has the power to tax, it cannot exercise this power so as to interfere with a state's exercise of its reserved powers.[124] The power to establish state courts to enforce state laws was not delegated to the federal government in the Constitution. Thus, it was reserved to the exclusive jurisdiction of the states under the Tenth Amendment.[125] As such, the federal government could not interfere with the state's exercise of its power by taxing it.[126] *Day* established a broad understanding of the implied immunity of states in that almost any tax on a state would be unconstitutional – even an indirect one that only taxed the salary of a state employee.[127]

This broad reading was narrowed in 1905 in *South Carolina v. United States*.[128] The Court found that the sale of liquor by a state is subject to federal excise taxes.[129] The Court was concerned that absolute immunity of states from taxation would endanger the ability of the federal government to raise revenue.[130] At the time, the federal government relied primarily on excise taxes for revenue. If the states were to take over the activities that were subject to the excise taxes – such as the sale of liquor – and then claim immunity from tax, the federal government's revenue would dwindle, impairing its ability to exercise its power.[131] To balance the need of the states to operate without federal

123. 78 U.S. 113 (1870).

124. Id. at 128.

125. See id.

126. Id. at 125-26.

127. Of course, under our modern version of the federal income tax, all individuals are subject to taxation under IRC § 1 regardless of whether they are employed by a state government. The federal government collects income tax from state employees and state governments collect state income tax from federal employees living or working within their jurisdiction. Thus, *Collector v. Day* was overruled in *Graves v. New York*, 306 U.S. 466 (1939). *Graves* actually dealt with an attempt by a *state* to tax the salary of a *federal* employee. The Court held in *Graves*, however, that a state could subject a federal employee to its income tax *and* concomitantly that the federal government could tax the salary of a state employee. Id. at 487. *Graves* was based on the reasoning that the taxation of federal employees by states or state employees by the federal government was "but the normal incident of the organization within the same territory of two governments, each possessing the taxing power" and the burden of this tax affected the federal or state governments only indirectly or incidentally. Id. The tax was indirect, and therefore not barred by the Constitution. Despite this overruling, the basic premise established in Collector v. Day – that the states have an implied constitutional immunity from certain federal taxation—remains valid to this day.

128. 199 U.S. 437 (1905).

129. Id. at 463. Today, state liquor stores, like any other state activity, are not subject to the federal income tax. See discussion infra Part III.B.

130. Id. at 455.

131. Id.

interference and the need of the federal government to have revenue for it to operate, the Court crafted a proprietary/governmental distinction.[132] Activities of the states that are governmental in nature may not be taxed but proprietary activities may be taxed. The Court did not provide much analysis for this conclusion, other than to note that this distinction was akin to that used to determine whether a municipality could be sued for negligence.[133] The Court did take comfort, however, in the theory that the framers of the Constitution did not believe that the states would engage in proprietary activities and thus did not intend to create a constitutional tax exemption for state commercial ventures.[134]

In a subsequent case, *Flint v. Stone Tracy Co.*,[135] which upheld a federal excise tax on businesses – including state controlled railroad corporations – the Court articulated the *South Carolina* governmental-proprietary distinction as follows:

> It is no part of the essential governmental functions of a state to provide means of transportation, supply artificial light, water, and the like. These objects are often accomplished through the medium of private corporations, and though the public may derive a benefit from such operations, the companies carrying on such enterprises are nevertheless private companies, whose business is prosecuted for private emolument and advantage. For the purpose of taxation they stand upon the same footing as other private corporations upon which special franchises have been conferred.[136]

This was the state of the intergovernmental immunity doctrine at the time the Sixteenth Amendment, giving the federal government the power to impose an income tax, was ratified in 1913.[137] It was *Flint's* "essential governmental function" language that was codified in section 115 when the income tax was enacted.[138] While this language has survived in section 115 to

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132. Id. at 463 ("…whenever a State engages in a business which is of a private nature that business is not withdrawn from the taxing power of the Nation").

133. Id.

134. Id. at 457. For a critique of the Court's ruling, see Wells & Hellerstein, supra note 122 at 1083 (stating that "…the governmental-proprietary distinction had no solid analytical justification…").

135. 220 U.S. 107 (1911).

136. Id. at 172.

137. "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. Const. amend. XVI.

138. The legislative history of IRC § 115 is discussed at infra Part III.B.1.

this day, the constitutional immunity doctrine continued to evolve beyond this simple distinction.[139]

In fact, the essential governmental function requirement was abandoned entirely in 1946 in *New York v. United States*.[140] The Court held that the sale of bottled water from the state-owned Saratoga Springs was subject to federal excise tax.[141] While this result seems appropriate in light of *South Carolina* – if the sale of liquor could be taxed, surely the sale of water could be taxed as well – the Court used a different analysis. The Court found the essential governmental function requirement to be unworkable: "To rest the federal taxing power on what is 'normally' conducted by private enterprise in contradiction to the 'usual' governmental functions is too shifting a basis for determining constitutional power and too entangled in expediency to serve as a dependable legal criterion."[142] The role of states continues to evolve over time and it is difficult to tell at any given point whether a state is engaging in a governmental function or in a commercial enterprise. For example, the sale of liquor by a state may be commercial, but it also may represent the exercise of the state's police power in regulating the distribution of alcoholic beverages.

Instead of focusing on whether or not a state activity is governmental, the Court in *New York* focused on whether the tax at issue is discriminatory:

> Only a State can own a Statehouse; only a State can get income by taxing. These could not be included for purpose of federal taxation . . . without taxing the State as a State. But so long as Congress generally taps a source of revenue by whomever earned and not uniquely capable of being earned by a State, the Constitution does not forbid it merely because its incidence falls also upon a State.[143]

Thus the concern of the intergovernmental tax immunity doctrine is protecting the states from being "singled out" for taxation.[144] This basic discrimination based test remains the crux of the current intergovernmental immunity doctrine.[145]

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139. IRC §115 and the statutory "essential governmental function" requirement are discussed at infra Part III.B.

140. 326 U.S. 572 (1946). This was a plurality opinion with the court's decision announced by Justice Frankfurter.

141. Id.

142. Id. at 580.

143. Id. at 582.

144. Id. at 584-85. (Rutledge, J., concurring).

145. See Richardson, supra note 116, at 424-31. Richardson also notes that it has been established that *indirect* taxes that fall on states are also judged for constitutionality based on discrimination. For example, there is no constitutional problem with "nondiscriminatory income taxes imposed by one government on

Before leaving the constitutional area, one should note that recently at least one case regarding the federal regulation (not taxation) of states has stated that there may not be as much of a need for broad immunity because the states have political power and thus can protect themselves from oppressive regulation through their representation in Congress.[146] It remains to be seen whether this "process protection" rationale will be imported into the realm of taxation and thus weaken the intergovernmental immunity doctrine.[147]

B. Section 115 and Implied Statutory Immunity

The constitutional immunity discussed above establishes the limits of what Congress *could* do in taxing states. Congress (at least in the view of the IRS) has never gone as far as the Constitution allows. Note that the constitutional cases above dealt with federal excise taxes, not income taxes. This is because, at least in the IRS's view, Congress, with one narrow exception,[148] has never imposed the federal income tax on the states. This section briefly reviews the history of section 115 and then reviews in detail how the IRS has determined that the states should be treated under the IRC.

1. Legislative History of section 115 – As noted above, section 115 codified the implied constitutional intergovernmental immunity doctrine as it existed at the passage of the Sixteenth Amendment.[149] Thus, under *South*

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employees of another government; imposed on the income derived by private parties from oil and gas leases acquired from the other government; or imposed by one government on sales to persons dealing with the other government." Id. at 431. Further discussion on indirect federal taxes that may affect states is beyond the scope of this Article.

146. Garcia v. San Antonio Metro. Trust Auth., 469 U.S. 528, 552-55 (1985).

147. One commentator has noted that process protection has worked even better in the area of taxation than in the area of regulation: "Notwithstanding enormous pressure on Congress to raise revenue, and the fact that a number of state activities are proprietary in nature, Congress has never imposed the income tax on states except in one narrow area." Richardson, supra note 116, at 452. This will become evident in Part III.B., infra.

148. IRC § 511(a)(2)(b) applying UBIT to the UBTI of state colleges and universities. See discussion supra Part II.B.2.

149. The predecessor to IRC § 115 was first passed as part of the Tariff Act of 1913. Richardson, supra note 116, at 460. As originally enacted, the statute read as follows: "[T]here shall not be taxed under this section any income derived from any public utility or from the exercise of any essential governmental function accruing to any State, Territory, or the District of Columbia, or any political subdivision of a State, Territory, or the District of Colombia . . . ." Tucker, supra note 116, at 514-15 n. 96. (There was also some transitional language relating to certain utility contracts and bridge acquisitions that are not relevant to the discussion in this Article. Id.)

Carolina and *Flint*, Congress could not tax income derived from an essential governmental function but could tax other income earned by states.[150] Scholarly examinations of the legislative history indicate that the states were worried that the constitutional intergovernmental immunity doctrine may have been swept away by the broad language of the Sixteenth Amendment:[151] "Congress shall have the power to lay and collect taxes on incomes, *from whatever source derived* . . . ."[152] At the same time, Congressional lawmakers wanted to avoid any constitutional challenges to the new tax.[153] By simply codifying the implied constitutional immunity doctrine, whether or not it was really necessary,[154] Congress addressed both concerns.

Since 1913, the constitutional intergovernmental immunity doctrine has evolved (starting with *New York*) to a discrimination-based test,[155] but the essential governmental function test lives on in section 115. If this standard was "too shifting" for constitutional review,[156] is it also too shifting for statutory purposes? Fortunately, courts rarely need to answer that question because of the IRS's longstanding interpretation of section 115.

2. The IRS View of section 115: General Counsel Memorandum 14,407 and Beyond – Since 1935, the IRS has taken the position that Congress did not

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The language in the modern version of the statute is essentially the same as the version passed in 1913:

> Gross income does not include – (1) income derived from any public utility or the exercise of any essential governmental function and accruing to a State or any political subdivision thereof, or the District of Columbia; or (2) income accruing to the government of any possession of the United States, or any political subdivision thereof.

IRC § 115. The only notable difference is that the essential governmental function test does not apply to the District of Columbia or to United States possessions under today's version of the statute. There is no record of why this is so. See supra note 115.

150. South Carolina v. United States, 199 U.S. 437, 463 (1905); Flint v. Stone Tracy Co., 220 U.S. 107, 172 (1911).

151. Richardson, supra note 116, at 461-65. The states were also concerned about getting a tax exemption for their utility operations. Id. IRC § 115 explicitly states that income from public utilities is exempt. IRC § 115.

152. U.S. Const. amend. XVI (emphasis added).

153. Richardson, supra note 116, at 461-62.

154. At least one commentator has concluded that IRC § 115 should have no operative effect since all it did was codify the then-existing version of the intergovernmental immunity doctrine. Richardson, supra note 116, at 473. As will be seen, the IRS disagrees and uses IRC § 115 (often incorrectly in Richardson's view) when determining whether state activities conducted though separate entities are exempt from tax. Richardson posits that IRC § 115 was never meant to provide a tax exemption for such entities. Id. For an opposing viewpoint, see Aprill, supra note 96, at 427 n. 19.

155. New York v. United States, 326 U.S. 572, 582 (1946).

156. Id. at 580.

intend to impose the federal income tax on the states. In General Counsel Memorandum 14,407 ("GCM"), the IRS concluded that liquor stores run by the state of Montana were not subject to the federal income tax.[157] The IRS did not perform a constitutional analysis but rather reached this result by reviewing the structure of the IRC. The federal income tax is imposed on married and single individuals[158] and corporations.[159] The GCM first stated that a state was not an "individual" under the IRC "if for no other reason than that the credits and exemptions provided for an individual are obviously not applicable to a State."[160] The GCM then concluded that a state was not a "corporation" under the IRC either: "Clearly, with the possible exception of section 116(d) [predecessor to current IRC section 115], there is nothing . . . to indicate that States should be taxed as corporations, and the proper interpretation of that section indicates rather that States should not be so taxed."[161]

This conclusion seems unusual because if states were in fact not taxed under the IRC, then there would be no need to exempt certain of their income under section 115. The IRS dealt with this in the GCM by analyzing the language of section 115.[162] In short, the IRS determined that section 115 was not meant to apply to the income of states, but to income earned by corporations established by states to carry out state functions.[163] A state is not taxed by the

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157. Gen. Couns. Mem. 14,407, 1935-1 C.B. 103,107 (Jan. 28, 1935). Technically, the GCM was superseded by Rev. Rul. 71-131, 1971-1 C.B. 28, which provided an updated tax exemption for Montana's liquor stores. Rev. Rul. 71-131 was issued pursuant to the IRS's project to update rulings made before 1953. This updating project is set forth in Rev. Proc. 67-6, 1967-1 C.B. 576. Rev. Rul. 71-131, however, simply laid out the facts regarding Montana's liquor stores and then summarily concluded that the income from the stores was exempt from the federal income tax. Rev. Rul. 71-131 included no legal analysis. Therefore, the extensive legal analysis in the GCM continues to represent the foundation of the IRS's treatment of states and it is frequently cited. See, e.g., Rev. Rul. 77-261, 1977-2 C.B. 45 (citing the GCM as providing support for its holding that a state fund to invest excess cash balances of towns is exempt from tax despite the fact it was "superseded" by Rev. Rul. 71-131). It is appropriate that GCM 14,407 involved a liquor store—since by the time you are done reading it, you really feel the need to visit one.

158. IRC § 1.

159. IRC §11.

160. Gen. Couns. Mem. 14,407, 1935-1 C.B. 103,104 (Jan. 28, 1935).

161. Id. This should sound familiar since this was the same explanation given as to why tribes are not subject to tax. For states, this analysis was stated explicitly. For tribes, it was an unofficial explanation given after the fact to explain prior cryptic rulings. For tribes, the explanation is at least plausible. For states, however, the presence of IRC § 115 makes the conclusion that states are not covered by the IRC more unsettling.

162. Throughout this discussion, I refer to IRC §115. The GCM itself referred to the predecessor to § 115, § 116. The two provisions are substantially the same.

163. Gen Couns. Mem. 14,407, 1935-1 C.B. 103,104 (Jan.28, 1935).

IRC at all and thus all of its income – whether from taxes, liquor stores, or wherever – is not taxed. This would be the case whether section 115 existed or not. Only when a state chooses to engage in activities through an investment in a corporation will the essential governmental function test of section 115 be invoked.

This somewhat startling revelation is based primarily on two modes of analysis. First, the IRS reviewed the language of section 115 and determined that if that provision had been intended to exempt income earned by a state directly, it would have stated that any income "derived by a state" from an essential governmental function would be exempt.[164] Instead, section 115 says that any income "accruing" to any state derived from the exercise of any essential governmental function would be exempt:

> [T]he words 'accruing to' connote the receipt of income from a contract or investment rather than from an act of the recipient. The use of these words serves, if not to make clear that the income referred to must have been derived by an entity other than a State . . . at least to raise an ambiguity.[165]

Second, in an attempt to deal with this "ambiguity," the IRS reviewed how it has treated states for income tax purposes in the past. Since 1913, the IRS has construed section 115 as applying to corporations owned by or contracting with the states and has "failed to tax the direct income of any State."[166] Furthermore, the IRS has "made no effort to obtain income returns from States . . . or to determine by any other means whether any State . . . has had income of this nature."[167]

The GCM then concluded that this "tacit construction" of the federal income tax as not applying to States on their income earned directly is not the result of oversight.[168] The IRS cited the fact that it has fought to collect federal *excise* tax from states on proprietary activities, such as liquor sales.[169] Thus, the IRS was well aware that states were engaging in proprietary activities, yet made no attempt to collect federal income tax on earnings from such activities. Further, the tax law was reenacted several times over the years without change, perhaps indicating approval of the IRS's stance towards the states.[170] Finally, the GCM reviewed the legislative history of section 115 and concluded that the

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164. Id.

165. Id.

166. Id. at 105.

167. Id.

168. Id.

169. Id. See, e.g., South Carolina v. United States, 199 U.S. 437, 438-39 (1905).

170. Gen. Couns. Mem. 14,407, 1935-1 C.B. 103,106 (Jan. 28, 1935).

states and Congress were primarily concerned with public utilities and with corporations – not with the activities of the states themselves.[171]

All of this led the IRS to conclude, in language that would play a large part in the IRS's future interpretation of section 115:

> It may be assumed that Congress did not desire in any way to restrict a State's participation in enterprises which might be useful in carrying out those projects desirable from the standpoint of the State Government which, on a broad consideration of the question, may be the function of the sovereign to conduct . . . .[172]

While GCM 14,407 was technically superseded, it stands as the only detailed authoritative statement by the IRS on its interpretation of section 115 and remains the IRS's position to this day.[173] The IRS will only deal with section 115 issues when a state is operating through a separate corporation.

Even in the realm of state-owned corporations, the IRS has taken a very broad view of what constitutes an "essential governmental function." Without much in the way of analysis, it has concluded, for example, that a state run liquor store,[174] an investment fund,[175] and even a hotel associated with a convention center[176] are not subject to tax. It is rare for the IRS to find such corporations taxable.[177] This is because the IRS over the years has looked at the destination of the funds generated from the activity rather than the source of the funds.[178]

The destination of funds test applied in the rulings just discussed on state-owned corporations flowed in part from GCM 14,407's deference to the states in establishing the proper scope of their activities.[179] The GCM dealt with activities performed directly by the state and not through a corporation—and thus section 115 was not at issue. This broad deference to the states was

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171. Id.

172. Id.

173. See supra note 157.

174. Rev. Rul. 71-131, 1971-1 C.B. 28.

175. Rev. Rul. 77-261, 1977-2 C.B. 45.

176. Priv. Ltr. Rul. 2001-16-009 (Jan. 4, 2001).

177. E.g., City of Bethel v. United States, 594 F.2d 1301 (9th Cir. 1979). See discussion of this case starting at infra note 184 and accompanying text.

178. Compare the treatment of non-profit corporations under § 501. Such corporations are tested for UBTI under a source of the funds test. See supra Part II.B.2. This creates a disconnect when state owned corporations are also treated as 501 organizations or when state colleges and universities are subject to UBIT under IRC § 511(a)(2)(B). Aprill, supra note 96, at 444-48.

179. Gen. Couns. Mem. 14,407, 1935-1 C.B. 103 (Jan. 28, 1935). See text accompanying supra note 172.

expanded to cover state activity conducted through a separate entity, and thus subject to the requirements of section 115, in Revenue Ruling 77-261.[180] There, the IRS ruled that an investment fund established by a state to hold and invest the excess cash balances of municipalities was tax-exempt.[181] Even though the income was investment income – rather than tax receipts – it was exempt[182] because states and towns ultimately[183] used the income earned to fund government services. This destination of income test would come to be used, explicitly or implicitly, in other rulings. The use of this test virtually guarantees that so long as the income earned by the state-owned corporation is ultimately available to the state, it will be considered derived from an essential governmental function and thus exempt under section 115.

One rare contrary example, however, is *City of Bethel v. United States,*[184] where an entity owned by an Alaskan town was found to be subject to the federal income tax on profits from its liquor store. The issue was not whether the operation of a liquor store was an essential governmental function, but rather whether the income "accrued to" the town.[185] The entity did not remit the net profits of the store to the town and did not otherwise reflect any amount payable to the town on its books.[186] While the corporation running the liquor stores was ultimately closed down and all of the assets were distributed to the town, this was not enough to meet the accrual requirement in the court's view.[187] Thus, the courts appear to take the requirements of section 115 seriously – at least with respect to the accrual requirement. With the IRS's liberal views in this matter, however, it is unlikely that many cases like *City of Bethel* will wind their way to court.[188]

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180. Rev. Rul. 77-261, 1977-2 C.B. 45.

181. Id.

182. Note that even though the fund was found to be exempt from income taxes, it was still required to file a federal tax return because it was, after all, a corporation. Id.

183. The IRS also took a liberal view of the "accruing to" requirement of IRC § 115. Rev. Rul. 77-261, 1977-2 C.B. 45. Since the participants in the fund had "an unrestricted right to receive in their own right their proportionate share of the investment fund's income as it is earned, the fund's income accrues to them within the meaning of section 115(1)." Id. This was the result even though the fund income was not immediately distributed to the participating towns. Id. Cf. City of Bethel v. United States, 594 F.2d 1301, 1303 (9th Cir. 1979), discussed in note 184 and accompanying text, infra, in which the court took a stricter view of the accrual requirement by requiring actual receipt of the income by the town.

184. 594 F.2d 1301 (9th Cir. 1979).

185. Id. at 1302.

186. Id. at 1303.

187. Id. at 1302.

188. It is unclear why the IRS, given their liberal position on IRC §115, did not give up or otherwise settle the case. It should be noted that the liquor store entity in *City of Bethel* actually filed tax returns and paid taxes and then only later sued for a refund

Thus, states can do pretty much anything they want and not be subject to federal income tax since states fall outside the scope of the income tax provisions of the IRC. The only exception is the application of the unrelated business income tax ("UBIT") to state colleges and universities. State-owned corporations are not automatically exempt but will likely be considered exempt under the IRS's very broad interpretation of the "essential governmental function" and "accrue to" tests of section 115. The IRS stance can perhaps be explained by a desire to avoid constitutional concerns in light of the ambiguity in the IRC as to how states should be treated and to avoid difficult line-drawing problems in interpreting the essential governmental function requirement embodied in section 115. The IRS may not want to deal with this issue since even the Supreme Court ultimately discarded it as a defining principle in the constitutional immunity area.[189] Thus it seems that the IRS avoided the issue from the inception of the income tax and continues to avoid it to this day.[190]

Given the volume of commercial activities that states engage in on a tax-free basis, at least one commentator has suggested that the federal government should consider subjecting the states to UBIT on all of their unrelated activities.[191] Of course, it will be quite difficult to determine exactly which activities are unrelated to the broad purposes of a state government.[192] Given the long-standing administrative practice of the IRS to not tax states, such a tax would certainly require an act of Congress rather than a mere change in administrative interpretation of the IRC. Any tax would need to fall into the constitutional limitations explained above. Thus, it could not be targeted at state activities or discriminate against the states as states.

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claiming exemption under IRC § 115. *City of Bethel*, 594 F.2d at 1302. Perhaps with the revenue in hand the IRS was more inclined to take a harder stance in this case. Given the IRS's reliance on the destination of funds test in these cases, the IRS may also have been concerned that the money earned by the liquor store would never end up accruing to the town treasury. If the cash would never go to the town, then even the liberal destination of funds test would be failed.

189. New York v. United States, 326 U.S. 572, 580-81 (1946).

190. This is similar to the IRS's stance with respect to Indian tribes. The IRS likely avoided the tribal tax issue given the complexity of Indian law and the little revenue at stake. The IRS likely avoided the state tax issue given the constitutional issues and the ambiguity surrounding IRC § 115.

191. Aprill, supra note 96, at 497. There is at least one major problem with taxing states—it would deplete their revenue, presumably forcing them to assess higher taxes. If the state chooses to use an income tax or a property tax to make up the revenue, such amounts may be deductible by the payor in calculating her federal income tax. IRC §164. Thus, federal revenues will go up by the assessment of tax on the states, but would go down by the increased deductions for state taxes. Whether there is a net gain or loss to the fisc would need to be determined. Whether this would be an efficient flow of funds through the various governments would also need to be considered.

192. Aprill, supra note 96, at 468.

IV. ABILITY OF CONGRESS TO TAX THE INDIAN TRIBES

Congress has even more power to tax the Indian tribes than it does to tax the states. Indian tribes have less political clout than states – rendering it more difficult for them to protect their interests in Congress.[193] Furthermore, the tribes are not protected by intergovernmental constitutional immunity, as are the states. Two major attempts were recently made to tax the gaming operations of Indian tribes – one in 1995 and a second in 1997.[194] The debate over these proposals sheds some light on the power of Congress to impose a tax on Indian tribes.

A. The Regulation of Indian Gaming

While tribes are not subject to the federal income tax, they are subject to regulation by the federal government. Before reviewing the 1995 proposed tribal tax, it is important to understand the regulation of Indian gaming. The key law is the Indian Gaming Regulatory Act ("IGRA").[195] This law was passed to pacify the states, which had failed in their attempt to prohibit gambling on Indian reservations within their borders.[196] A detailed review of the regulation

193. Tribes, unlike states, have no representation in Congress, which puts them at a disadvantage. This does not mean, however, that tribes are powerless in political matters. To the contrary, many tribes have used their new income streams to become politically active, hiring lobbyists to protect their interests. See, e.g., *American Indian Tribes Fight Casino Tax Provision*, State Tax Today, Oct. 18, 1995, LEXIS, 95 STN 201-29, (reporting that the National Indian Gaming Association has hired a former House Ways and Means Committee lawyer and a former Senate Finance Committee lawyer to fight a proposed tax on Indian tribes); David Lightman & Jon Lender, *Gaming Tax Faces Fierce Criticism, Rowland Joins Opposition to Plan*, Hartford Courant, June 11, 1997, at A1 (reporting that Indians have a "powerful lobby," that the Mashantucket Pequots (owners of Foxwoods casino) have a full time lobbying office in Washington, ties to the Clinton administration, and have contributed to both the Democratic and Republican Parties). Despite this new political power, the tribes are not afraid to play the "poverty card." See Robert Pear, *Small Items in Budget Bills Yield Big Benefits for Special Interests*, N.Y. Times, Nov. 6, 1995, at A1 (quoting a spokeswoman for the National Indian Gaming Association (which represents 140 tribes): "they think they can tax us because Indian people don't have a lot of votes and are among the poorest people in the United States").

194. See infra Part IV.B.

195. Codified at 25 U.S.C. §§ 2701-2721 (2000).

196. This failure resulted from the Supreme Court's ruling in *California v. Cabazon Band of Mission Indians*, 480 U.S. 202 (1987), which held that California (or counties within California) may not regulate federally approved bingo and card games taking place on Indian reservations located within the borders of the state (or county). Id. at 221-22. Indian tribes have a sovereign status that is subordinate to the federal government, but not to the state government. Id. at 207. Therefore, the federal government must authorize state regulation of Indian activities for them to be valid. The

of Indian gaming is beyond the scope of this Article, but some of the key provisions are summarized here.[197]

First, the IGRA divides gaming into classes. Class I gaming includes ceremonial or traditional Indian games.[198] Such games are not regulated by the IGRA[199] and tend to generate insignificant revenues.[200] Class II gaming includes bingo and related games and certain card games.[201] Class III gaming includes all other games.[202] Thus, Class III includes most casino type games, such as blackjack, craps, slot machines, etc. Both Class II and Class III gaming are subject to regulation under the IGRA.[203] Class III gaming may only be conducted with the consent of the state in which the tribe is located under a Tribal-State compact. [204]

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federal government has granted the states the ability to regulate certain *criminal* acts on Indian reservations within their borders, but has not given the states broad jurisdiction to regulate *civil* matters on Indian reservations. See Canby, supra note 3, at 284-85. The Court in *Cabazon* viewed the regulation of Indian gaming as civil/regulatory in nature rather than criminal in nature – and thus beyond the power of the states. *Cabazon*, 480 U.S. at 211-12. The Court emphasized the fact that the gaming activities were consistent with federal policy encouraging the self-sufficiency and economic development of Indian reservations. Id. at 216. Thus, state regulation of Indian gaming was prohibited and pre-empted by federal law. Id. at 221-22. *Cabazon* set the stage for the expansion of Indian gaming and led to the passage of the IGRA – which "provided novel responses to the competing regulatory claims of the federal government, the states, and the tribes" over Indian gaming. Canby, supra note 3, at 287. Under the IGRA, the states were given a voice in tribal gaming taking place within their borders via the chance to negotiate a Tribal-State compact with the tribes wishing to operate casinos. See infra note 204.

197. For a comprehensive analysis of the IGRA and a history of Indian gaming in general, see William E. Horwtiz, *Scope of Gaming Under the Indian Gaming Regulatory Act of 1988 After* Rumsey v. Wilson*: White Buffalo or Brown Cow?*, 14 Cardozo Arts & Ent. L.J. 153, 155-66, 172-74 (1996).

198. 25 U.S.C. § 2703(6) (2000).

199. 25 U.S.C. § 2710(a) (2000).

200. Canby, supra note 3, at 288.

201. 25 U.S.C. § 2703(7) (2000).

202. 25 U.S.C. § 2703(8) (2000).

203. 25 U.S.C. § 2710(a)(2), (d) (2000).

204. 25 U.S.C. § 2710(d)(1) (2000). A detailed discussion of Tribal-State compacts is beyond the scope of this Article. One point is relevant, however, to the discussion of policy issues in infra Part V. Compacts may include provisions whereby the tribe agrees to make certain payments to the state government (not called "taxes"). Kevin K. Washburn, *Indian Gaming: A Primer on the Development of Indian Gaming, the NIGC and Several Important Unresolved Issues*, A.B.A. Center for Continuing Legal Education (Feb. 7-8, 2002), WL N02GENB ABA-LGLED D-1. These are generally allowed only where there is consideration for the payment—for example, where the state grants the tribe a monopoly to operate slot machines. Id. Payments can be significant. For example, Connecticut is entitled to 25% of the monthly slot machine revenue earned at the Foxwoods and Mohegan Sun Casinos under its compacts with the Mashantucket Pequot and the Mohegan tribes. Rick Green, *Slots Revenue Rises 5.4%*,

Tribes are restricted in how they may spend the net revenues from Class II or Class III gaming operations. Such net revenue may only be used: 1) to fund tribal government programs or operations; 2) to provide for the general welfare of the tribe and its members; 3) to promote tribal economic development; 4) to donate to charitable organizations; or 5) to help fund the operations of local government agencies.[205] If a tribe creates a revenue allocation plan to fund these items and the Secretary of the Interior approves the plan, the tribe may distribute any excess funds to members of the tribe on a per capita basis.[206] Such distributions are taxable to the individual tribal members receiving them.[207] In fact, the distributions are subject to withholding at the source.[208]

These provisions provide broad latitude to the tribes as to how to spend their gaming revenue while attempting to ensure that the tribe or tribal members benefit from the net revenues rather than private individuals. If a tribe is in substantial violation of the IGRA, the National Indian Gaming Commission – the federal agency charged with overseeing the IGRA – may assess civil fines or shut down the tribe's casino operations temporarily or permanently.[209]

B. Proposed Income Tax on Gaming Income

Against this regulatory backdrop, Congress in 1995 considered imposing the UBIT on Indian tribes.[210] Under the proposed law, Indian tribes

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Hartford Courant, Nov. 16, 2002, at B5. Since the casinos opened (Foxwoods in 1992 and Mohegan Sun in 1996), the tribes have remitted approximately $2.3 billion to the state of Connecticut. Id.

205. 25 U.S.C. § 2710(b)(2)(B) (2000) (referring to Class II gaming); 25 U.S.C. § 2710(d)(1)(A)(ii) (2000) (applying § 2710(b) to Class III gaming).

206. 25 U.S.C. § 2710(b)(3) (2000) (referring to Class II gaming); 25 U.S.C. § 2710(d)(1)(A)(ii) (2002) (applying § 2710(b) to Class III gaming). Procedures for requesting Department of Interior approval of revenue allocation plans is set forth at 25 C.F.R. § 290 (2002). As of February, 2002, the Secretary of the Interior had approved approximately sixty tribal revenue allocation plans. Washburn, supra note 204.

207. 25 U.S.C. § 2710(b)(3)(D) (2000). The tribe must notify the tribe members of this tax obligation when the payments are made. Id.

208. IRC § 3402(r). Only distributions with respect to Class II & III gaming revenue are subject to withholding. This presumably means that such revenue should be tracked separately from Class I and other revenue. As noted above, however, Class I revenue is usually not material.

209. 25 U.S.C. §§ 2705(a)(1)-(2); 2713(a)(1)-(b)(1), 2706(a)(5) (2000). See, e.g., United States v. Santee Sioux Tribe of Nebraska, 135 F.3d 558 (8th Cir. 1998) (upholding an order of the National Indian Gaming Commission to close a gaming facility that was being operated by the Santee Sioux tribe without a state-tribal compact as required by the IGRA).

210. The information on the proposed tax was taken from Kathleen M. Nilles, *Commentator Says Tax on Tribal Gaming Would be Unconstitutional*, Tax Notes Today, Nov. 30, 1995, LEXIS, 95 TNT233-40 [hereinafter Foxwoods Memo]. Nilles's piece was commissioned by the Mashantucket Pequot Tribe, which operates the Foxwoods casino in Connecticut. Id. Attached to the Foxwoods Memo was a reprint of M.

would, in general, have still been considered beyond the income tax provisions of the IRC, but would have been subject to UBIT on net revenue from Class II and Class III gaming operations.[211] Unlike some other tax-exempt organizations, however, they would only be allowed to deduct ten percent of their net gaming revenues for charitable and other required contributions.[212]

The Congressional Research Service (CRS) reviewed the proposed gaming tax for constitutional issues and concluded that there was no constitutional bar to taxing the tribes on their gaming revenue.[213] Much of the discussion in this section is taken from the CRS Memorandum ("CRS Memo")

Maureen Murphy, Congressional Research Service Memorandum: Constitutionality of Taxing Gambling Income of Indian Tribes, October 10, 1995 [hereinafter CRS Memo]. The CRS Memo concluded that there was no constitutional bar to the proposed tax. As will be seen, the Foxwoods Memo took issue with the CRS Memo's conclusions.

The tax proposed in 1995 died in the Senate. David Lightman, *Indian Casino Taxes Rejected*, Hartford Courant, June 13, 1997, at A1. The tax proposal, however, re-emerged in 1997. Id. Although it had the strong support of House Ways and Means Committee Chairman Bill Archer, the bill failed to make it out of the House Ways and Means Committee. Id. The bill was defeated in a 22-16 vote when several Republican members broke ranks with the Chairman, largely out of concern for treading on the sovereignty of the tribes. Id.

211. CRS Memo, supra note 210. In general, the idea was that tribes would be treated like tax exempt organizations with respect to their gaming revenue just as they (and states) are treated like tax exempt organizations on any unrelated income of colleges and universities that they operate under IRC § 7871(a)(5) & IRC § 511(a)(2)(B).

212. CRS Memo, supra note 210. Other tax-exempt organizations that are required by law to expend income on charity are allowed to deduct such payments against their UBTI – effectively eliminating the UBIT. See South End Italian Independent Club, Inc. v. Commissioner, 87 T.C. 168, 177 (1986) (holding that required payments to charity be deducted as a business expense under IRC § 162 rather than as charitable contributions—which would be limited under § 170). Indian tribes, under the IGRA, are required to use the Class II and III gaming revenue primarily in governmental or charitable endeavors. Even though the law requires these contributions, the proposed tax would limit deductions for payments under the IGRA to 10% of net gaming revenues. CRS Memo, supra note 210. If this limitation were not in the proposed law, much of the tribe's "taxable income" would be eliminated and the tax would fail to raise much revenue.

213. "The Congressional Research Service is the public policy research arm of the United States Congress. As a legislative branch agency within the Library of Congress, CRS works exclusively and directly for Members of Congress, their Committees and staff on a confidential, nonpartisan basis." Congressional Research Service, *About CRS,* at http://www.loc.gov/crsinfo/whatscrs.html (last visited Feb. 25, 2003) (on file with the author). Its opinions, therefore, represent nonpartisan research reports rather than binding legal precedent.

on the proposed tax and the National Indian Gaming Association's response ("Foxwoods Memo").[214]

Underlying the debate over whether the tribes can be taxed is the tribe's unique relationship to the federal government. First, it is important to note that Congress's power over the Indian tribes is plenary.[215] While Indian tribes are considered "sovereign," Congress can and has interfered with that sovereignty on numerous occasions.[216] There is no provision in the Constitution reserving certain powers to the tribes. Therefore, the tribes have no developed constitutional intergovernmental tax immunity like that enjoyed by states. To the contrary, the Constitution provides for Congressional control over Indian affairs through the Indian Commerce Clause.[217] The relationship between the tribes and the federal government is a unique one that "resembles that of a ward to his guardian."[218]

Tribes do enjoy a level of self-government either by statute or by treaty. Any statue or treaty, however, can be overturned by an act of Congress. In order to do so, there must be "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."[219] A recent review of the cases in this area concluded, "because the notion of Indian sovereignty is flexible it does not bar [federal] taxation."[220]

There are no rulings confirming Congress's power to apply the federal income tax to the tribes. At least one Supreme Court case dealing with *state* taxation, however, may shed some light on Congress's ability to subject the

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214. See supra note 210.

215. See Cherokee Nation v. Georgia, 30 U.S. 1, 17, 19 (1831) (describing Indian tribes as "domestic dependent nations" and finding that the power over the Indian tribes is vested exclusively in the federal government).

216. Canby, supra note 3, at 85-87. "As yet, however, no court has found a constitutionally protectible interest in tribal sovereignty by itself, and numerous examples exist of federal statutes limiting it." Id. at 85. Canby cites the Major Crimes Act as just one example of interference with tribal self-government. The IGRA could be viewed as another. "[S]overeignty exists entirely at the sufferance of Congress. Political restraints may, of course, keep Congress from eliminating or greatly diminishing tribal sovereignty, but legal restraints do not." Id. at 87. "The sovereignty that the Indian tribes retain is of a unique and limited character. It exists only at the sufferance of Congress and is subject to complete defeasance." United States v. Wheeler, 435 U.S. 313, 323 (1978). This would suggest that Congress could even abolish the Indian tribal system if it so desired. Of course, in doing so Congress would have be sure to structure matters so as not that to run afoul of the Just Compensation and Due Process Clauses of the Fifth Amendment. See Conference of Western Attorneys General, American Indian Law Deskbook 8 (Julie Wrend & Clay Smith eds., 2d ed. 1998).

217. *Cherokee Nation*, 30 U.S. at 19.

218. Id. at 17.

219. United States v. Dion, 476 U.S. 734, 740 (1986).

220. Dean, supra note 10, at 159.

tribes to *federal* taxation. In *Mescalero v. Jones*, the Court ruled that states can subject tribes to taxation on their off-reservation activities.[221] Specifically, the tribe in *Mescalero* was found to be taxable on the operation of its off-reservation ski resort.[222] The tribe had leased the land underlying the ski resort from the federal government pursuant to the IRA.[223] The IRA provided that any land acquired by tribes under its provisions would be exempt from state and local taxation.[224] The Court found that Congress, in drafting the IRA, only intended the land acquired under its provisions to be exempt from state taxes.[225] The exemption did not extend to income earned from the land. Since Congress did not exempt the income from state taxation, the CRS Memo concludes that Congress affirmatively permitted such taxation and "if Congress may subject the proceeds of tribal activity to state taxes, it certainly may subject them to the federal income tax."[226] *Mescalero*, however, addressed taxes assessed on off-reservation activities. Most of the gaming operations at issue in the proposed federal tax are on-reservation activities. The CRS Memo does not address this distinction.

The Foxwoods Memo counters with two basic arguments. First, it argues that Congress can only interfere with Indian tribal self-government when it is consistent with the government's trust function over the Indian tribes and that imposing a tax on the tribes would be a violation of the trust function.[227] As noted above, however, Congress's power over the Indians in plenary and Congress is free to interfere in tribal affairs when it sees fit.[228]

The Foxwoods Memo also claims that the proposed tax would create an equal protection violation in that tribes would be treated differently from states and differently from tax-exempt organizations engaging in gaming activities.[229] They would be treated differently from states in that state gambling operations (e.g., lotteries) used to fund governmental activities would not be subject to the tax. Tribes would also be treated differently from tax-exempt organizations in that they would not be allowed to deduct payments that they are required to make under the IGRA.[230] "To ignore this difference is to suggest that Congress could impose a tax on automobiles made by General Motors, but not Ford, and sustain its constitutionality."[231]

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221. 411 U.S. 145, 157-58 (1973).

222. Id. at 145

223. Id. at 146.

224. Id. at 155.

225. Id. at 157.

226. CRS Memo, supra note 210. See also supra note 51.

227. Foxwoods Memo, supra note 210.

228. See supra note 216.

229. Foxwoods Memo, supra note 210. It should be remembered that equal protection jurisprudence is often invoked when nothing else will work—it has been called "the usual last resort of constitutional arguments." Buck v. Bell, 274 U.S. 200, 208 (1927).

230. See supra note 212.

231. Foxwoods Memo, supra note 210.

First, this statement compares two governmental entities (tribes and states) earning money in the same way (gambling) and using the funds for the same purpose (to fund governmental services). Neither the CRS Memo nor the Foxwoods Memo, however, addresses another area of equity: Whether it is appropriate for the federal government to tax the casino operations of private enterprises such as MGM Grand and the Mirage, but not to tax the Mohegan Sun Casino or the Foxwoods Casino simply because they are owned by Indian tribes.

Second, the Supreme Court in *Chickasaw Nation v. United States*[232] recently sanctioned such a difference in treatment between states and tribes. There, the Supreme Court found that Indian tribes were subject to certain gaming excise taxes from which the states are exempt.[233] No equal protection arguments were addressed by the Court.[234] While a detailed discussion of *Chickasaw* and federal excise taxes is beyond the scope of this Article, suffice it to say that if a federal waging tax could be assessed against tribes but not states, it would seem that the same could be said for a federal income tax.

Finally, even assuming *arguendo* that an equal protection argument would work in this context, the proposed tax could be modified to eliminate the problem. For example, the states could be subjected to UBIT on their lottery income.[235] Then states and tribes (and private gambling enterprises) would be treated equally. Of course, this outcome is unlikely given the political muscle of the states.

Thus, there appears to be no blanket constitutional protection for Indian tribes. Furthermore, Congress could overturn any previously granted treaty or statutory immunity so long as it is explicit in doing so. In addition, *Mescalero*

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232. 534 U.S. 84 (2001).

233. Id. at 87-88.

234. Simplifying greatly, the arguments in the case were primarily over statutory construction. The IGRA included provisions subjecting tribes to the same treatment as states with respect to certain *withholding and reporting obligations*. Id. at 87. The IGRA, however, listed the federal excise tax on gaming as an example of one of those "withholding and reporting" obligations even though the provision listed had nothing to do with withholding and reporting. Id. Since states were exempt from the excise tax to which the IGRA referred, the tribe claimed that the IGRA exempted them from the tax as well. Id. The Court ruled that the reference to the excise tax was a bad one but that it should not invalidate the statute or establish an exemption from taxation. Id. at 90-91. In doing so, the Court favored the canon of construction that tax exemptions must be clearly expressed if they are to be respected over the canon that assumes that Congress generally intends to benefit the tribes in its legislation. Id. at 95. Thus, under the Court's interpretation of the IGRA, tribes are subject to the excise tax but states are exempt from the excise tax. Id. at 87-88.

235. While Congress has the power to enact such a tax, it is unlikely that such a tax would ever be enacted given the political clout of the states and their long-standing, near-total tax-exempt status. See supra Part III. See also supra note 147. For further discussion on state lotteries, see infra Part V.A.2.

may provide at least some support specifically in the tax area. Thus it appears clear that Congress could tax the Indian tribes if it desired to do so.

V. SHOULD INDIAN TRIBES BE SUBJECT TO THE FEDERAL INCOME TAX?

It now appears fairly certain that Congress can tax the Indian tribes. The bigger and more provocative issue is, should it? To date, only one commentator has broached this issue, concluding that tribes should be taxed.[236] While taxing the tribes would address unfair competition issues between the tribes and private commercial enterprises, doing so would interfere with current and long-standing federal Indian policy and tax policy. This Part explores these policy concerns and concludes that, in light of these policies, the tribes should retain their tax-free status. Part V.A reviews whether tribes should be treated as states or businesses for tax purpose, concluding that treatment as states would be more appropriate. Part V.B then explores other issues – including the impact on federal, state, and tribal revenues – that should be considered in deciding whether to tax the tribes.

A. Indian Tribes Should be Treated Like Governments – and Taxed As Such

1. Introduction: The Classification Issue – The push to tax the tribes was driven by two motivations. First, the tribes were seen as an easy target for taxation – an easy source of revenue.[237] Second, the proposed tax was meant to

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236. Dean, supra note 10. Dean's piece is primarily on Indian sovereignty and whether the federal government has the power to tax the tribes. In closing, however, she offers a few arguments for taxing the tribes. She makes no arguments against taxing the tribes. The following is a summary of Dean's arguments and some brief reactions to them:

(1) A tax would redistribute wealth from the rich (casino-owning) tribes to the poor tribes. Id. at 178-182. It is doubtful, however, in the absence of some sort of earmarking that the revenue raised would be used to help the poorer Indian tribes. The proceeds from such a tax would likely go into general revenue.

(2) A tax would address unfair competition between Indian tribes and commercial casinos. Id. at 182-83. This is a genuine concern and it is therefore discussed in this Part. Dean makes no comparison, however, between the treatment of state lotteries and the Indian casinos.

(3) A tax would help pay for the negative social consequences of gambling. Id. at 183-84. These include traffic and crowding costs incurred by surrounding towns. Id. This seems to be more of a local (rather than federal) taxation issue, however, that is presumably better addressed in the state/tribe compact required by the IGRA than by a tax imposed on Indian tribes.

237. David Lightman & Jon Lender, *Gaming Tax Faces Fierce Criticism, Rowland Joins Opposition to Plan*, Hartford Courant, June 11, 1997, at A1. See also David Lightman, *Some See Tax Jackpot at Indian Casinos*, Hartford Courant, July 19, 1994, at A1 (reporting earlier discussions of taxing the tribes and quoting Senator Joseph Lieberman (D-CT): "This is nothing against the tribes. This is a matter of

address complaints by the commercial gambling industry and small business interests of unfair competition.[238] Private business corporations pay federal income tax at rates up to 35 percent, thus retaining only 65 percent of their net profits. Tribes pay no federal income tax and thus keep 100 percent of their net profits.[239] This clearly creates a competitive advantage for Indian tribes. This also violates horizontal equity – the idea that two similarly situated taxpayers should pay the same amount of tax. This is only true, however, if tribes are properly viewed as business enterprises. If they are viewed as governments – like states (which are free to engage in substantial commercial activities free from tax) – then taxing the tribes would *create* a horizontal equity problem.

The problem here is one of classification: Indian tribes are not pure governments and they are not pure business enterprises. If they must be forced to be viewed as one or the other, however, they should be viewed as governments – and treated like states for tax purposes. This is not because the Constitution requires it, but because Indian policy respecting the sovereignty of the Indian tribes demands it. The discussion below makes this clear. First, Part V.A.2 examines how states are just as aggressive as tribes in running their proprietary gambling operations and concludes that it would not be fair to tax the tribes, and yet leave the states untaxed. Part IV.A.3 then reviews the current status of federal Indian policy – which is based on recognizing the tribes as governments. Taxing the tribes would frustrate this important and long-standing policy. Finally, Part IV.A.4 reviews the legislative history of the Indian Governmental Tax Status Act of 1982, which brought state and tribal taxation closer together in light of federal Indian policy.

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looking for money"). The issue of the amount of revenue a tribal tax would generate is discussed at infra Part V.B.

238. See David Lightman & Jon Lender, *Gaming Tax Faces Fierce Criticism, Rowland Joins Opposition to Plan*, Hartford Courant, June 11, 1997, at A1 (reporting that "[t]hose pushing for the gaming tax [on tribes] include many private gaming companies, which have long thought the tribal casinos have an unfair advantage, and some small business interests, which see tribes gaining a financial edge in other areas"); Robert Pear, *Small Items in Budget Bills Yield Big Benefits for Special Interests*, N.Y. Times, Nov. 6, 1995, at A1 (quoting the reaction of ITT Corporation (owner of Caesars Palace and other casinos) chairman Rand V. Araskog to the proposed UBIT on tribes: "Hurrah, It's terrific. Tax-free Indian casinos are springing up all over the place. Indians operate some of the most profitable casinos in the world. If they were not tax-free, a lot of these gaming operations would not have gotten started"); Robert Whereatt, *Are Casinos Holding An Unfair Tax Advantage?*, Star Trib., Dec. 27, 1992, at A1, LEXIS, MAJPAP File (reporting that owners of small businesses located near a Minnesota Indian reservation cannot compete with the tribe because Indian tribes "enjoy a government-sanctioned, unfair advantage: a lower tax burden").

239. The tribes argue that in fact 100% of their profits are taxed – either because the profits must go to meet governmental or other expenditures listed in the IGRA or because per capita payments are taxable to the recipients. See id. (reporting that tribal casino operators view their profits as "the same thing as corporate taxes").

2. The States Like Gambling Too – Reviewing the gambling activities of states shows that states and tribes operate in a similar manner – and therefore should be taxed in a similar manner. Most states, like Indian tribes, raise revenue through gambling.[240] While Indian gaming is a $12.7 billion industry,[241] state lotteries have become a $40 billion industry.[242] States increasingly have operated their lotteries just like businesses – employing sophisticated marketing techniques to increase sales.[243] In fact, the states have carefully copied the tactics of "the lucrative private-sector gambling industry . . . ."[244] States are directing their lottery officials to "view their mission like any other business" and to "go out and make money" – leading lotteries to engage in "activities that are inconsistent with the broader goals of state government."[245] Yet, Congress

240. As noted in supra Part III, states are engaged in a variety of commercial enterprises in addition to gambling. The discussion here focuses on gambling, however, since it represents a classic example of how the tribes and states operate similarly. Similar arguments could be made for other commercial ventures engaged in by tribes and states.

241. National Indian Gaming Association, *Indian Gaming Facts,* at http://indiangaming.org/library/index.html (last visited Feb. 25, 2003) (on file with the author). For more financial information on Indian gaming, see supra note 5.

242. Rick Green, *Playing Games: States Manipulate Lottery Dreamers; Scratch-Off Tickets Aimed at Vulnerable Targets*, Hartford Courant, Oct. 6, 2002, at A1. Thirty-eight states have lotteries. Id. Most of the growth in state lotteries has been the result of instant "scratch-off" games. Id. Such games, traditionally sold for $1, are now offered in "higher-stakes" versions. See id. For example, Connecticut recently celebrated its lottery's thirtieth birthday by offering a $30 scratch-off ticket. Id. Players have a one in fifty-five chance of recouping their investment and a one in a million chance to win $300,000. Id. These higher-end offerings result from the state's need to compete with the two major Indian casinos in Connecticut (Foxwoods and the Mohegan Sun) for its share of its citizens' gambling dollar. Id.

243. See Id. The Hartford Courant recently researched the marketing techniques of state lotteries throughout the United States, obtaining confidential marketing plans in the process. Id. It found that states increasingly hire outside marketing firms to survey the public and conduct focus groups to gather data on consumer preferences. Id.. This information is then used in designing games and marketing campaigns to increase purchases. Id. Some states, such as Oregon, have chosen to target younger players. Id. Other states, such as Wisconsin, have targeted those with lower education and income. Id.. States often employ "manipulative" techniques to boost sales – by focusing ad campaigns on the "fun" of playing the lottery and by emphasizing the benefit to the state treasury. Id.

244. Id. Even Nevada, the home of the world-famous Las Vegas casinos, is currently considering implementing a lottery even though it may compete with private gaming interests in the state. *Nevada Task Force Votes to Recommend Lottery*, State Tax Today, Oct. 8, 2002, LEXIS, 2002 STT 195-18.

245. Jack Dolan & Rick Green, *Playing Games: The Poor Play More*, Hartford Courant, Oct. 7, 2002, at A1 (quoting Duke University economist Charles Clotfelter for these propositions).

has chosen to target Indian gaming for taxation, while leaving state lotteries untouched.

States lotteries view themselves as competing with Indian casinos.[246] As Indian gaming has grown, "[state] lotteries across the country have become more aggressive designing their instant or 'scratch' games to mimic slot machines and table games . . . ."[247] States already have one advantage over Indian casinos in that state lottery tickets are available at the corner convenience store – no travel to an Indian reservation is required.[248] Taxing Indian gaming profits – but not lottery profits – would give states yet another advantage over the Indians in competing for consumers' gambling dollar.

While the states compete with Indian casinos, they also benefit from them. States often negotiate to receive a percentage of casino revenue as part of the Tribal-State compact required by the IGRA.[249] For example, Connecticut receives 25 percent of the slot machine revenue earned at the two Indian casinos in the state under its compact with the tribes.[250] To date, Connecticut has received over $2.3 billion from the tribes under the compact.[251] This is simply gambling income. Yet, if tribes were subjected to the unrelated business income tax, their 75 percent share of slot machine income would be subject to tax while the 25 percent that went to the state would be exempt from tax. This is true even though the state and the tribe would use the income for the same purpose – to fund governmental activities.[252]

While states are just as aggressive as Indian tribes in pursuing gambling revenue, they in fact receive most of their revenue from taxation. Thus, states

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246. Rick Green, *Playing Games: States Manipulate Lottery Dreamers; Scratch-Off Tickets Aimed at Vulnerable Targets*, Hartford Courant, Oct. 6, 2002, at A1.

247. Id.

248. Id. The Hartford Courant notes that "[u]nlike [Indian] casinos in Connecticut, the lottery's 'convenience store gambling' is available nearly everywhere, at 2,800 locations statewide." Id. The advantage that states enjoy over Indian casinos is even more evident when it comes to poorer customers: "Because many [poor people] can't hop into a reliable family car to test their luck at one of the casinos in southeastern Connecticut – which give much better odds – the availability of lottery tickets in thousands of bars, gas stations and corner stores gives the state a substantial monopoly on legal gambling among the poor." Jack Dolan & Rick Green, *Playing Games: The Poor Play More*, Hartford Courant, Oct. 7, 2002, at A1. Casino games generally pay out between 80% and 90% of the amount wagered while the Connecticut lottery only returns approximately 65%. Id. See also David Brunori, *The Politics of State Taxation: My Favorite Martians*, State Tax Today, Oct. 15, 2002, LEXIS, 2002 STT 199-2 (musing that "Your chances of winning Powerball are about as good as your chances of being elected prime minister of Mars").

249. See supra Part IV.A for a discussion of the IGRA.

250. Rick Green, *Slots Revenue Rises 5.4%*, The Hartford Courant, Nov. 16, 2002, at B5.

251. Id.

252. In fact, the tribe is regulated in how it could spend the money under the IGRA. See supra Part IV.A.

are less likely to *need* to rely on gambling and other commercial income in funding governmental activities.[253] The situation is much different for Indian tribes. In the absence of casino gambling or other commercial enterprises, it could be very difficult for tribes to fund government activities. "Economically depressed, with little tax base . . . tribes, however, have little alternative for public finance."[254] The Supreme Court has also taken note of this situation in *California v. Cabazon Band of Mission Indians*:

> The tribal games at present provide the sole source of revenues for the operation of the tribal governments and the provision of tribal service. They are also the major sources of employment on the reservations. Self-determination and economic development are not within reach if the Tribes cannot raise revenues and provide employment for their members.[255]

Thus, it may be that taxing a tribe's casino profits would be akin to taxing a state's tax revenue.[256] It would be patently unfair to tax tribes on their

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253. The use of state lotteries has been severely criticized as being a highly regressive manner in which to raise funds. See Brunori, supra note 248 (stating that there is no justice in a system where most of the money "is coming from poor folks who stand in line at the 7-11 waiting for the numbers that will never come in"); David Brunori, *The Politics of State Taxation: Vinny, Viagra, and Vegas*, State Tax Today, Oct. 21, 2002, LEXIS, 2002 STT 203-12 (stating that the "government brings the [gambling] vice right to your door by inundating you with advertisements" and that "lotteries are all about raising revenue from people who do not realize they are being taxed").

254. Barsh, supra note 10, at 553-54.

255. California v. Cabazon Band of Mission Indians, 480 U.S. 202, 218-19 (1987). This case is discussed at supra note 196.

256. Of course, with established casinos and associated businesses, many tribes now have a much greater tax base. Its members are employed and could pay tribal taxes. Thus, gambling has improved the possibility of maintaining a tax base. Therefore, it is possible that the costs of taxing gaming revenue may be passed on to tribal members in the form of reduced per-capita payments or in some form of a tribal tax. Tribes have complained of a double taxation problem that makes it difficult to attract business. The state taxes businesses and so does the tribe – discouraging business development on Indian reservations. See Testimony of Peterson Zah, President of the Navajo Nation, Before the Committee on Ways and Means (March 16, 1993) reprinted in Tax Notes Today, Mar. 17, 1993, LEXIS, 93 TNT 61-109. The presence of a casino, however, is likely to attract business regardless of any additional tribal tax. This double tax problem could be reduced if the state allows a deduction (or better yet, a credit) for taxes paid by corporations to Indian tribes. Most states, however, require taxes measured by income to be added back to federal taxable income in calculating state taxable income. CCH, 2002 State Tax Handbook 252-53 (2001). The add-back is usually referred to as state or foreign income taxes but presumably, in the absence of a special statute on the subject, this could encompass income taxes paid to Indian tribes. A detailed review of

sole source of revenue while allowing states to generate supplemental funds through lotteries on a tax-free basis.

3. Tribes Are Considered Governments Under Federal Indian Policy – Current federal Indian policy also favors treating tribes like states. Congress should not exercise its plenary power and tax the Indian tribes if it would frustrate important goals of federal policy towards the Indians. Tax policy should not be decided independently of Indian policy.

While federal Indian policy has varied over the years, since the early 1970s a cornerstone of federal policy has been economic development of the tribes through tribal self-determination.[257] In reaffirming this policy, President Reagan noted that "responsibilities and resources should be restored to the governments which are closest to the people served. This philosophy applies not only to State and local governments but also to federally recognized American Indian tribes."[258] Under federal Indian policy, there is a "government-to-government" relationship between the tribes and the federal government.[259]

Thus, the federal government views tribes like governments. If Congress is to follow this policy, it should treat the tribes as governments for tax purposes. Since state governments, with one narrow exception, are not

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tribal taxation powers and its interrelationship with state taxation is beyond the scope of this Article.

257. Canby, supra note 3, at 29-32. A detailed recounting of the history of federal Indian policy is beyond the scope of this Article. For an overview of this history, see id. at 10-32. A couple of points should be noted for background, however. The Indian Reorganization Act of 1934 ("IRA") was the first major step taken by the federal government to recognize that tribes should be preserved (permanently) and should be self-governing. Id. at 23-25. The IRA is discussed at supra Part II.A.2. The IRA was designed to "stabilize the tribal organizations" and to "permit Indian tribes to equip themselves with devices of modern organization, through forming themselves into business corporations." Felix S. Cohen, Handbook of Federal Indian Law 84 (1942). This emphasis on self-government was abandoned, however, in the 1950s and was replaced with an "assimilation" approach in which tribes were to be terminated and Indians assimilated into the general population. Canby, supra note 3, at 25. The assimilation policy was viewed as a failure, and thus in the 1970s federal policy towards the Indians returned to one of encouraging self-determination and self-government. Id. at 29-32. This remains the cornerstone of federal Indian policy to this day. Id. at 32. See also *California v. Cabazon Band of Mission Indians*, 480 U.S. 202, which is discussed in supra note 196. In *Cabazon*, the Court acknowledged that it must "proceed in light of traditional notions of Indian sovereignty and the congressional goal of Indian self-government, including its 'overriding goal' of encouraging tribal self-sufficiency and economic development." Id. at 216.

258. Ronald Reagan, *Indian Policy: Statement of Ronald Reagan, January 24, 1983*, reprinted in Documents of United States Indian Policy 301 (Francis Paul Prucha ed., University of Nebraska Press 1990).

259. Id. This "government to government" relationship was also reaffirmed by President Clinton in 1994, ironically just one year before the first UBIT on Indian tribes was proposed in Congress. Canby, supra note 3, at 31-32.

taxed,[260] Indian tribes should not be either. Taxing the tribes would be a real and symbolic attack on this concept of a government-to-government relationship. A federal income tax would trample on traditional and modern notions of Indian sovereignty and self-determination. While Congress has used its plenary power to interfere with Indian sovereignty in the past,[261] imposing an income tax on the tribes would take such interference to a new level. The tax treatment of states and tribes would be so different that it would be difficult for the federal government to continue to claim that it was truly in a government-to-government relationship with the Indian tribes. Taxing the tribes would provide a solid "no" to the question posed many years ago by Indian law expert Felix S. Cohen: "Will the promises of self-government . . . actually be fulfilled or will these promises be treated like so many earlier promises of the United States embodied in solemn treaties with the Indian Tribes?"[262]

Obviously, the federal government is free to change its Indian policy, as it has done in the past.[263] If federal policy were changed to view the tribes as businesses rather than governments, then certainly a tax on the tribes would be appropriate. To date, this change has not occurred. Until it does, tax and Indian policy can only be aligned by exempting the tribes from the federal income tax.

4. Lessons From the Indian Governmental Tax Status Act of 1982 – Congress has, in the past, recognized the importance of aligning tax policy with Indian policy. The Indian Governmental Tax Status Act of 1982 ("the 1982 Act")[264] illustrates this. Prior to this law, Indian tribes were not treated like states for any purposes of the IRC[265] In enacting the 1982 Act, Congress felt that because Indian tribes were viewed as sovereign governments under prevailing federal Indian policy, they should be treated like states for certain tax purposes:

> Indian tribal governments have responsibilities and needs quite similar to those of State and local governments. . . . Increasingly, Indian tribal governments have sought funds with which they could assist their people by stimulating their tribal economies and by providing governmental services.

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260. See supra Part III.

261. See supra note 216 for examples.

262. Cohen, supra note 257, at 87. See also William L. Raby, *Indian Tribes and Income Tax Exemption: "They Can't Take That Away From Me?"* Tax Notes Today, June 10, 1992, LEXIS, 92 TNT 120-70 (speculating that the federal government may someday decide to tax Indian tribes, and that if they did "[i]t would not be the first time Washington has tried to take something away from the Indians").

263. See supra note 257.

264. Codified primarily at IRC § 7871. See supra Part II.B.1 for a discussion of § 7871.

265. S. Rep. No. 97-646, at 10 (1982), reprinted in 1982 U.S.C.C.A.N. 4580, 4588.

> The committee has concluded that, in order to facilitate these efforts of the Indian tribal governments that exercise such sovereign powers, it is appropriate to provide these governments with a status under the Internal Revenue Code similar to what is provided for the governments of the States of the United States.[266]

Of course, the 1982 Act did not address the federal income tax treatment of tribes – and thus did not state that tribes would be treated like states for purposes of the federal income tax.[267] Congress, however, did not need to say anything on this front. The legislative history acknowledged that both states and tribes were both generally exempt from the federal income tax (under different authorities)[268] prior to the 1982 Act. Further, Congress made it clear that Revenue Ruling 67-284,[269] acknowledging the tax-exempt status of the tribes, remained untouched by the 1982 Act.[270] Thus, Congress noted that tribes and states both enjoyed similar exemptions from the federal income tax – albeit under different authorities – and chose to leave those separate – but substantially equal – exemptions in place. This seems to imply that Congress, in aligning the tax treatment of the tribes and the states, did not feel it was necessary to explicitly align these exemptions in the 1982 Act since they were already, in reality, aligned.[271] Reading the legislative history in this way, it appears that Congress, in light of federal Indian policy, wanted tribes and states to be on an equal footing for federal tax purposes, even though a provision to that effect was not included in the 1982 Act.

In the twenty years since the 1982 Act became law, overall federal Indian policy has not substantially changed. As noted above, sovereignty and self-determination are still the hallmarks of modern federal Indian policy. Therefore, taxing the Indian tribes would disrupt the alignment of Indian policy and tax policy in place since the 1982 Act.

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266. Id. at 11 (1982).

267. See supra note 77 and accompanying text. The 1982 Act did, however, treat tribes as states for purposes of applying UBIT to the unrelated income of tribal colleges and universities. See supra Part II.B.2.

268. For the states, the legislative history lists § 115 as providing the exemption. S. Rep. No. 97-646, at 8 (1982), reprinted in 1982 U.S.C.C.A.N. 4580, 4586. Of course, this is an overly simplistic view of how states obtained their tax exemptions. See discussion at supra Part III. For the tribes, Rev. Rul. 67-284 is listed as providing the exemption. S. Rep. No. 97-646, at 8 (1982), reprinted in 1982 U.S.C.C.A.N. 4580, 4586.

269. Rev. Rul. 67-284, 1967-2 C.B. 55. See discussion at supra Part II.A.1.

270. S. Rep. No. 97-646, at 12 (1982), reprinted in 1982 U.S.C.C.A.N. 4580, 4590.

271. The one finishing touch that Congress did feel was necessary to align the tax treatment of tribes and states was the provision of § 7871 treating tribes as states for purposes of applying UBIT to the unrelated income of tribal colleges and universities. See discussion at supra Part II.B.2.

5. Summary – Tribes are really more like states than they are private businesses. States are just as aggressive as (and compete with) Indian tribes in their commercial endeavors – particularly when it comes to gambling. Furthermore, federal Indian policy views tribes as self-determinative governments that should have the opportunity to pursue economic development activities. Tax policy – evidenced by the 1982 Act – has and should continue to follow this federal Indian policy of self-determination. All of this shows that tribes should be taxed like states. Since states are not taxed under current law, neither should tribes.

Of course, keeping tribes and states aligned from a tax standpoint fails to address the unfair competition problem that admittedly exists between tribes and commercial businesses. However, this problem has existed for years between states and commercial businesses – and yet Congress, with one exception, has never sought to tax the states. The unfair competition problem cannot be solved by singling out tribes for taxation. Rather, both states and tribes would need to be subject to taxation on their commercial income to truly address the issue. If states were subjected to tax, tribes should be as well. This is very unlikely to happen, given the political clout of the states.[272] Therefore, the best we can hope to do at this point is to simply keep tribes and states on an equal tax footing. To do otherwise would add more inconsistency to a taxing regime already plagued by horizontal equity problems – namely the inconsistent treatment of state commercial ventures (not taxed) and private commercial ventures (taxed) and non-profit commercial ventures (generally taxed under the unrelated business income tax regime).

B. Other Concerns

Aside from major issues of tax policy and Indian policy, there are also a couple of other issues that should be considered when it comes to taxing the tribes. This section briefly explores these issues.

1. The Perception Problem – There is a widespread belief that Indians do not pay taxes at all.[273] The public sees Indian gaming expanding and comes to resent the fact that Indians can "get rich" off of gaming but then pay no tax.[274]

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272. See supra notes 147 and 235.

273. See supra note 30.

274. See supra note 30. Aside from the tax issue, a broader perception problem should be noted. There is a perception that certain tribes (particularly newly recognized tribes in the East) with large casinos are not "real" Indians but rather are "phony Indians . . . fronting for gambling interests." Rick Green, *Tribal Leaders Decries 'Scare Tactics'*, Hartford Courant, Nov. 13, 2002, at B1. This notion was advanced by a recent book questioning the heritage of the Mashantucket Pequot Tribe (which owns the Foxwoods casino in Ledyard, Connecticut). See Jeff Benedict, Without Reservation 1-4 (2000) (reporting, for example, that a future tribal chairman listed himself as being "white" on a 1969 marriage license application). For an opposing viewpoint on this

People will only comply with a self-assessment tax system – such as we have in the United States – if they believe the system is fair and equitable. Thus, exempting tribes from tax may pose challenges to the tax system itself. This problem, however, is based on a fundamental misconception. Individual Indians in fact pay federal income tax – and are clearly taxed on the per capita payments they receive out of tribal gaming income. Tribal governments operate like state governments – whose tax-free status is rarely questioned. Furthermore, tribal gaming income is subject to regulation under the IGRA and per capita payments must be approved by the Department of Interior.[275] Therefore, the solution to this "perception" problem is not a tax, but rather education and awareness of the true tax status of Indians and tribes.

Related to the perception problem is the concern over tribes using their tax-free status in tax shelters. While one tax shelter has been shut down,[276] others may be on the horizon. Wide-open, unchecked exemption as is currently in place may stoke a fire that may already be out of control. Subjecting the tribes to UBIT would effectively end tribes' participation as accommodating parties in tax shelter transactions. It could, of course, turn the tribes into actual purchasers of tax shelters! Standing on its own, however, tax shelter participation is not strong enough a reason to warrant the imposition of a tax. Indian tax shelters can be attacked just like any other tax shelter – by specific, targeted legislation or enforcement.[277]

2. Measuring the Revenue – Finally, the amount of revenue that is lost by exempting the tribes should be determined. This will be necessary in order to determine whether taxing the tribes is worth the trouble. The 1997 version of the proposed tax on tribes was estimated to raise approximately $1.9 billion in revenue over five years.[278] It is unclear how this estimate was calculated, however, and whether it considered all of the complexities involved.

One complexity is that gaming revenue is already taxed once when distributed as per capita payments to individual Indians.[279] Thus, the fisc is only missing the potential corporate tax at the tribal level. If a tax were to be

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issue, and a critique of Benedict's book, see David Cournoyer, *Can't Indians Be Successful?*, Denver Post, June 7, 2000, at B11. Arguments over this matter will no doubt continue, and they will somewhat influence public attitude towards Indians with successful gaming interests. For purposes of this Article, however, it should be recalled that all tribes that have been recognized by the federal government are entitled to federal tax exemption—regardless of whether their legitimacy is in question by critics. See supra Part II. Therefore, this issue will not be discussed further.

275. See supra Part IV.A.

276. See supra Part II.B.3.

277. This was exactly what was done with the shelter described in supra Part II.B.3.

278. David Lightman, *Indian Casino Taxes Rejected*, Hartford Courant, June 13, 1997 at A1.

279. 25 U.S.C. § 2710(b)(3)(D) (2000).

imposed, presumably the tribes would reduce their per-capita payouts to tribe members to make up the difference. This would reduce the tax collected from the individual tribe members. Alternatively, the tribes could impose a tax to make up the shortfall in revenue. Such taxes are deductible by the payor under section 164.[280] This also would lower the amount of tax collected by the federal government. The impact of a tax on payments made under state-tribal compacts would also need to be factored into the equation.[281] In the end, an empirical analysis is required – one that takes account of the effect of a tax on tribes, tribal members, states, and the federal government.

VI. CONCLUSION

A lot has changed in Indian country. Not much has changed in tax country. Despite the economic growth of many Indian tribes brought about by Indian gaming, there has been no major overhaul to the federal tax treatment of Indian tribes. The tax story remains the same – Indian tribes, with one minor exception, are not subject to the federal income tax. States have a similar status, although they escaped the grip of the IRC by a much more heavily documented, but extremely confusing path. This Article has attempted to expose and highlight the complexities underlying these statuses and to revisit them in light of the realities of the new millennium.

Despite the changes in Indian country, it appears that federal tax policy towards Indian tribes is best kept at the status quo. Tribes, while increasingly commercial in nature, are governments and should be treated as such under the tax system. Therefore, tribes should continue to be exempt from the federal income tax – just like states. While Congress has the power to tax the tribes, to do so would frustrate long-standing federal Indian policy favoring the economic independence and sovereignty of the tribes and end Congress's recent movement towards treating Indian tribes as states for many purposes of the tax code. Unless and until there are major changes in tax policy towards states or federal policy towards Indian tribes, imposing the federal income tax on tribes would not be justifiable.

We have not heard the last of this issue. As Indian gaming expands and the government searches for new sources of tax revenue, there will no doubt be pressure to impose some sort of an income tax on the tribes. When this issue re-emerges, any new proposals must be evaluated, as done here, in light of prevailing Indian policy and tax policy. In addition, empirical studies of the complex revenue impact on tribes, states, and the federal government would

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280. IRC § 164. As noted in supra Part II.B.1., the deduction is allowed for taxes paid to Indian tribes courtesy of § 7871(a)(3).

281. See David Lightham & Jon Lender, *Gaming Tax Faces Fierce Criticism; Rowland Joins Opposition to Plan*, Hartford Courant, June 11, 1997, at A1 (reporting the state of Connecticut's unquantified concern that the 1997 proposed federal income tax on tribal income would reduce the state's share of revenue from Indian casinos under the state's compact with the Mashantucket Pequot and the Mohegan tribes).

need to be done to properly measure the true amount of potential tax revenue at stake. Only then can we, like the weekend gambler, know how much money we are leaving on the table, and whether we are better off for having done so.