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Can a State Tax the Fuel That Is Sold by Non-Indian Distributors to a Tribal Gas Station

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Case at a Glance

Kansas seeks to impose its motor fuel taxes on non-Indian distributors of gas at on-reservation tribal gas stations. The Prairie Band Potawatomi Nation claims these taxes would impermissibly interfere with tribal and federal interests and would prohibit the tribe from imposing its own taxes to maintain reservation roads. The Court must decide how to evaluate state taxation that affects on-reservation economic activities.

INDIAN LAW

Can a State Tax the Fuel That Is Sold by Non-Indian Distributors to a Tribal Gas Station?

by Bethany Berger

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Issue

Can a state impose taxes on fuel delivered by an off-reservation, non-Indian distributor to an on-reservation, tribally owned gas station if the gas station customers are primarily patrons and employees of the tribe's adjoining casino and the tax would prevent the tribe from imposing its own tax on fuel sales?

Facts

State taxation of reservation activity has long been a flashpoint for conflicts between tribes and states. In recent decades, tribes, with federal encouragement, have pursued economic development in order to raise revenues for government services and increase employment among tribal members. Freedom from state taxation aids this economic activity and permits tribes to impose their own taxes. However, tribal lands are located within state borders, and states have their own sovereign interests in tax collection. As more revenue is generated on reservations and more non-Indians engage in commercial activity there, states have become more concerned with loss of customers and tax revenues to on-reservation businesses. In some states, these conflicts have been resolved with negotiated state-tribal taxation agreements. In other states, however, unresolved conflicts have resulted in multiple cases before the Supreme Court and bitter—at times violent—battles between states and tribes.

The case now before the Court is just one of four challenging collection of state fuel taxes since Kansas authorized collection of taxes on motor fuel distributed to reservation gas stations in 1995. See *Sac & Fox Nation of Missouri v. Pierce*, 213 F.3d 566 (10th Cir. 2000); *Winnebago Tribe of Nebraska v. Kline*, 2005 WL 1683970 (D. Kan.); *Kaul v. Kansas Department of Revenue*, 970 P.2d 60 (Kan. 1998). In 1992, Kansas entered into five-year intergovernmental compacts with each of the four tribes within its borders. It agreed not to impose taxes on fuel sold at reservation gas stations so long as the tribes

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imposed their own taxes amounting to "not less than sixty percent" of the state tax. In 1995, however, the state amended its fuel tax statute to remove the exemption for fuel delivered to retailers on Indian reservations. Kan. Stat. Ann. § 79-3401 *et seq.* In 1997, when its tax compacts with the tribes expired, the state declined to renew them.

When the state attempted to collect taxes on fuel sold to a gas station owned and operated by the Prairie Band Potawatomi Nation, the tribe sued to enjoin collection. In 2003, the U.S. District Court for the District of Kansas granted summary judgment to the state, dismissing the lawsuit. *Prairie Band Potawatomi Nation v. Richards,* 241 F.Supp. 1295 (D. Kan. 2003). In 2004, the Tenth Circuit reversed, holding that because the profits of the gas station were the result of value generated by the tribe on its reservation, federal law preempted the state taxes. *Prairie Band Potawatomi Nation v. Richards,* 379 F.3d 979 (10th Cir. 2004).

The tribe built the gas station, known as the "Nation Station," at a cost of $1.5 million to serve individuals driving to the tribe's nearby casino. The gas station is located on tribal land approximately one and half miles down a road that the tribe built and maintains to provide access to its casino. The road connects to State Highway 75, which is the main highway connecting the reservation to major population centers. Kansas does not provide the tribe with assistance in maintaining the road to the casino and gas station. The gas station is not visible from the state highway, and its gas is sold at within two cents a gallon of the prevailing market rate. Its draw, therefore, is not the price of gas or the state highway, but its proximity to the tribe's casino. Seventy-three percent of the Nation Station's customers are patrons or employees of the casino; an additional 11 percent are either employees of other tribal businesses or reservation residents.

The tribe purchases gas for the station from a non-Indian distributor located off reservation. The tribe imposed tribal taxes of 16 cents per gallon of gasoline sold at the station at the time the litigation was brought and raised these taxes to 20 cents per gallon in 2003. (Taxes on diesel fuel were initially 18 cents a gallon and increased to 22 cents in 2003.) The tribe's annual revenue from the tax is about $300,000 per year. The tribe uses all of this revenue to help maintain 118 miles of road on the reservation. The remaining 45 percent of the roads on the reservation, including the major roads that connect the reservation to other parts of the state, are maintained by state and local governments. The state imposes a fuel tax of 23 cents per gallon on gasoline and 25 cents on diesel and uses the revenue from this tax to defray the cost of road construction and maintenance. Kan. Stat. Ann. § 79-34,141 & 79-3425. The state provides part of this fuel tax revenue to county and city governments for road maintenance but does not provide fuel tax revenue to the tribe. Kan. Stat. Ann. § 79-3425. The tribe's expert testified and the Tenth Circuit agreed that the tribe could not impose both the tribal and state taxes and continue to sell gas.

Case Analysis

State taxing power in Indian country frequently turns on whom state law requires to pay the tax—in other words, on who bears the "legal incidence" of the tax. If the legal incidence of the tax falls on a tribe or its members, the state may not impose the tax unless congressional authorization of the tax is unmistakably clear. See *Oklahoma Tax Commission v. Chickasaw Nation,* 515 U.S. 450 (1995). If, however, the legal incidence of the tax falls on non-Indians or on Indian nonmembers of the tribe, then the state may impose the tax unless it is preempted by federal law or would impermissibly infringe on tribal sovereignty. *Oklahoma Tax Commission v. Chickasaw Nation,* 515 U.S. 450 (1995); *White Mountain Apache Tribe v. Bracker,* 448 U.S. 136 (1980).

The Court has relied primarily on preemption analysis in evaluating state taxes, incorporating tribal sovereignty as a factor in the test. In the Indian law context, federal law need not "expressly" preempt state taxes. Instead, the Court interprets federal intent against a backdrop of tribal sovereignty and federal protection of that sovereignty. This interpretation, in turn, requires a "particularized inquiry into the nature of the state, federal, and tribal interests at stake, an inquiry designed to determine whether, in the specific context, the exercise of state authority would violate federal law." *White Mountain Apache Tribe v. Bracker,* 448 U.S. 136 (1980); see *Cotton Petroleum Corp. v. New Mexico,* 490 U.S. 163 (1989); *Ramah Navajo School Board v. Bureau of Revenue of New Mexico,* 458 U.S. 832 (1982). The Tenth Circuit relied on this "balancing test" in rejecting the state fuel tax. The State of Kansas now asks the Supreme Court to rule that this test should no longer be applied.

The Court first clearly applied a balancing test in *Washington v. Confederated Tribes of the Colville Indian Reservation,* 447 U.S. 134 (1980). There, the Court held that the State of Washington could impose its cigarette taxes on the sales of cigarettes to non-Indians by reservation tribal retailers even

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though the imposition of this state tax would dry up the tribal business, which was generated wholly by the market for tax-free cigarettes. In that case, the Court emphasized that the tribes were essentially "marketing a tax exemption" and that although they did have an interest in generating tribal revenue, "that interest is strongest when the revenues are derived from value generated on the reservation by activities involving the Tribes and when the taxpayer is the recipient of tribal services."

In subsequent cases in which a substantial portion of the value was generated on reservation, the Court held that the state's interest cannot be a generalized interest in raising revenue or the provision of services to the non-Indian taxpayer off-reservation or unrelated to the taxed activity but must include an on-reservation contribution to the value taxed. *Ramah Navajo School Board v. Bureau of Revenue of New Mexico,* 458 U.S. 832 (1982); *White Mountain Apache Tribe v. Bracker,* 448 U.S. 136 (1980). Applying the test, the Court in 1987 held that California could not regulate gambling by non-Indians at tribal bingo halls, as the tribes had generated the value themselves by building and running the facilities, and the state interest in the activity was not significant. *California v. Cabazon Band of Mission Indians,* 480 U.S. 202 (1987). The Court has also applied the test to strike down state fuel taxes on non-Indians contracting with a tribal timber industry, *White Mountain Apache Tribe v. Bracker,* 448 U.S. 136 (1980), and state income taxes on a non-Indian contractor building an on-reservation school. *Ramah Navajo School Board v. Bureau of Revenue of New Mexico,* 458 U.S. 832 (1982). In both of these cases, the Court found significant federal regulation of the activity taxed and so did not rely on tribal value and general federal interests alone. In *Cotton Petroleum Corp. v. New Mexico,* 490 U.S. 163 (1989), the Court held that the balancing test permitted state taxes on non-Indians for oil and gas extracted from reservation lands, even though the tribe substantially contributed to regulation of the industry, when there was a small but "substantial" contribution by the state to on-reservation oil and gas extraction.

The decision by the Tenth Circuit in the case now before the Court presents a very clean question regarding the proper application of the "value added" portion of the balancing test. In contrast with *Colville,* the Prairie Band Potawatomi Nation sells its gas at market prices, eliminating the specter of non-Indian businesses being undersold by tribes marketing a tax exemption. Both the casino that draws potential fuel purchasers to this rural corner of the state and the road that leads them there were built and maintained by the tribe. The gas station was built and is owned and operated by the tribe and is largely staffed by tribal employees. Although *Colville* and *Cotton Petroleum* both rejected arguments that tribal taxes preempted duplicative state taxes, this is the first case in which a tribe proved in the lower courts that the imposition of state taxes would prevent the tribe from imposing its own taxes. The tribe and its amici argue that there is a compelling federal interest in the tribal ability to impose fuel taxes to generate revenue to improve reservation roads. They cite a 2003 federal report calling the reservation road system "among the most rudimentary" in United States. The report noted that the vast majority of these roads are unpaved and "resemble roads in developing nations." In response, the state argues that the tribal road leading to the gas station is itself only accessible by State Highway 75, which the state maintains, and that most of the gas station's customers live off the reservation and receive state services. In their amicus brief, the National Association of Convenience Stores, the Petroleum Marketers Association of America, and Society of Gasoline Marketers of America emphasize that the value of the gas itself is created off reservation.

However, the state focuses its arguments on the contention that the balancing test should not be applied to state taxing jurisdiction at all. It asks the Court to take up then-Associate Justice William H. Rehnquist's suggestion in his concurrence in *Colville* that a balancing of interests is inappropriate and prevents the development of coherent principles governing state taxation in Indian country. The state petitioner, joined by amicus Multistate Tax Commission, asks the Court to replace the preemption test as the Court has developed it with a test that would require there be specific congressional intent before a court could hold a state tax on non-Indians preempted by federal law. This test, they argue, would prevent case-by-case litigation in this area of law, increase predictability, and create bright lines for tax administration. As they point out, in 1995 the Court rejected requests by the State of Oklahoma to apply a balancing test to that state's taxation of tribal members, stating that a categorical test in that area served the need for predictability in tax liability. *Oklahoma Tax Commission v. Chickasaw Nation,* 515 U.S. 450 (1995). In that case, however, the Court was following the trend of its past opinions. Since *Colville* was decided, the Court has repeatedly, including in opinions by the late Chief Justice Rehnquist, affirmed and applied the balancing test.

The respondent tribe and its amici argue that the balancing test is a necessary accommodation of tribal sovereignty and the federal interests in preventing state interference with federal Indian policy. They argue that this accommodation is appropriate given the Indian Commerce Clause, which gives the federal government the power to regulate commerce with the Indian tribes and correspondingly limits state power in this area. They assert that the strict preemption test that the Petitioner proposes would result in state taxation of virtually all on-reservation commercial activity and contradict the federal policy of encouraging tribal economic development.

The parties have complicated the question before the Court by adding arguments not essential to the ruling below. The state, in an argument not addressed by either of the lower courts in this case, argues that even if the Supreme Court continues to apply the unique preemption test that it developed in the Indian context, that test should not be applied in this case because the fuel tax is a tax on off-reservation activity. Under the Court's decision in *Mescalero Apache v. Jones,* 411 U.S. 145 (1973), states are free to tax Indian activity outside reservation or Indian community boundaries absent clear federal law prohibitions. The Petitioner argues that because the "tax is imposed on the distributor of the first receipt of the motor fuel," Kan. Stat. Ann. § 79-79-3408(c), and first receipt of the motor fuel occurs outside the reservation, the Indian law preemption test is irrelevant.

The Respondent tribe and its amici argue that even if the incidence of the tax falls on the distributor, the tax itself is "imposed on the use, sale or delivery" of motor vehicle fuels, Kan. Stat. Ann. § 79-3408(a), and the sale or delivery of fuels occurs on the reservation. They point out that the distributor of first receipt need not pay taxes on fuels sold to another distributor or exported from the state and may claim a refund for taxes paid on fuel destroyed or lost before delivery. Kan. Stat. Ann. § 79-3417. Even if the taxable event in this case is not on the reservation, they argue, the Court's past cases have applied the preemption test in such situations so long as the taxes directly affected economic activity on the reservation. Several states submitted an amicus brief that did not opine on the location of the taxable activity in this case but urged the Court to affirm that the preemption test does not apply to activities outside reservation boundaries.

The tribe also argues that because the tax is actually on the on-reservation sale of fuel to the tribe, the tax is preempted by federal Indian trader statutes. Since 1790, elaborate statutes and regulations have governed the conduct of those selling goods and services to Indians on reservations. The Supreme Court has twice held that these statutes preempt state taxation of non-Indians for their on reservation sales to Indians. *Central Machinery Co. v. Arizona State Tax Commission,* 448 U.S. 160 (1980); *Warren Trading Post v. Arizona Tax Commission,* 380 U.S. 685 (1965). The state argues, however, that these cases concerned sales to tribes or their members for their own use, and that these cases have been limited by the Court's decision in *Department of Taxation and Finance v. Milhelm Attea,* 512 U.S. 61 (1994), which held that New York could impose extensive record-keeping requirements on retailers and wholesalers to enforce state cigarettes taxes on sales to non-Indians. The Tenth Circuit previously rejected the argument that the Indian trader statutes preempted Kansas's fuel tax in *Sac & Fox Nation of Missouri v. Pierce,* 213 F.3d 566 (10th Cir. 2000), and the lower court decisions in this case did not address this argument.

Amicus United States also argues that the legal incidence of the Kansas fuel tax actually falls on the tribal retailers and is therefore invalid. Where the legal incidence of a state tax lies is a question of interpretation of state law. While federal courts grant great deference to authoritative state interpretations of the law, the question is ultimately one for the federal courts to decide. The Kansas statute explicitly states that the incidence of the tax falls on the distributor of the fuel. The state apparently drafted the statute in this manner to ensure that it could tax gas distributed to tribal retailers. In the earlier litigation by the other Kansas tribes, the Tenth Circuit held that the legal incidence of the tax did in fact fall on the non-Indian fuel distributors. *Sac & Fox Nation of Missouri v. Pierce,* 213 F.3d 566 (10th Cir. 2000). The Tenth Circuit also relied on this holding in its decision in this case. The United States, however, argues that the Kansas Supreme Court held in 1999 that the statute read as a whole placed the legal incidence of the tax on retailers. *Kaul v. Kansas Department of Revenue,* 970 P.2d 60 (Kan. 1998). Petitioner responds that that decision concerned only the "standing" of the nontribal retailers to challenge the tax. The United States argues that the conclusion of the Kansas court is correct because the statute provides that distributors may collect the amount of the tax from retailers, and that signs posting fuel prices must clearly include the amount of the tax. Kan. Stat. Ann. § 79-3409. In addition, the United States points out, distributors need not pay the

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tax on fuel sold to retailers or users such as the United States or other states that are exempt from state taxes. Kan. Stat. Ann. § 79-3408(d)(1) & (2). In *Oklahoma Tax Commission v. Chickasaw Nation*, 515 U.S. 450 (1995), the Court stated that states were free to amend their statutes to shift the legal incidence of fuel taxes away from tribal retailers. In other contexts, however, the Court has emphasized that otherwise invalid taxes on tribal members were not made valid by changes in the "mere nomenclature" that did not change the function of the tax. *Washington v. Confederated Tribes of the Colville Indian Reservation*, 447 U.S. 134, 163-64 (1980); see *Oklahoma Tax Commission v. Sac and Fox Tribe*, 508 U.S. 114, 126-27 (1993).

SIGNIFICANCE

If the Court holds that explicit congressional preemption is necessary for non-Indians doing business with tribes to be exempt from state taxation, it will remove most of the immunity from state taxation held by those who do business with Indians on reservations. Under the test developed in *Colville*, much commercial activity with non-Indians is already subject to state taxation. Relying on *Colville*'s value-added test, however, tribes such as the Prairie Band Potawatomi Nation have developed businesses and industries in which they create most of the value themselves. A decision in favor of the tribe would encourage these efforts. A decision requiring explicit preemption would undermine them and largely prevent tribes from imposing their own taxes on the activity. It will also conflict with the federal policy of encouraging tribal self-determination by making exercise of tribal territorial sovereignty dependent on explicit federal consent. Such a decision should not, however, significantly affect tax treatment of gaming activities, as regulation of this activity is extensive, and the congressional intent to prohibit taxation of these activities is relatively explicit.

It is not clear what the effect of such a decision would be in reducing conflict and uncertainty in state taxation. One would think that a bright-line test would create more certainty than the multifactor preemption test. But tribal-state taxation questions seem to generate persistent conflict even when the test is fairly clear. In *Oklahoma Tax Commission v. Sac and Fox Tribe*, for example, the justices issued their third decision holding that states could not impose motor vehicle taxes on tribal members residing in Indian country, noting that two years earlier "we rejected precisely the same argument—and from precisely the same litigant." 508 U.S. 114, 124 (1993). In addition, the recent disagreements that resulted in violent conflicts between tribal officials and state police were ones in which state authority to tax was relatively established. In recent years, many tribes and states have been able to resolve these questions with intergovernmental tax agreements. Although hundreds of such compacts have been reached, the willingness of each side to negotiate has been based not only on a recognition of the benefits to each side in cooperating on tax collection, but also on the relative degree of uncertainty on the outcome of litigation. A bright-line rule that does away with this uncertainty may remove an incentive to negotiate and with it the cooperative resolution of many of these disputes.

If the Court holds that a state can by statute shift not only the legal incidence but also the location of the taxed activity so as to immunize it from Indian law preemption analysis, it will enable states to significantly increase their taxation of economic activity in Indian country. States will often be able to statutorily shift the tax "upstream" and so avoid the special analysis developed in the Indian context even when the tax will necessarily affect economic activity in Indian country. If, on the other hand, the Court decides that the location of the taxed activity is irrelevant for application of the preemption analysis, it will greatly extend the geographic reach of the special rules applicable to Indian taxation. Even if the Court rules in the tribe's favor, however, it could do so without creating such a test. It could instead hold that the statute itself makes the taxable event the use, sale, or delivery of the fuel and conclude that these events clearly occur on the reservation. If, however, the Court agrees with the United States that the tax is in fact on the retailer, this approach will undermine the apparent ease of shifting tax liability that the Court suggested in *Oklahoma Tax Commission v. Chickasaw Nation*, 515 U.S. 450 (1995).

Finally, it should be noted that state taxation in Indian country was an issue of special interest to the late Chief Justice Rehnquist. Since the passing of Justice Thurgood Marshall from the Court, he had been the strongest voice on the Court on this subject. The Court's decision in this case therefore may signal the direction the jurisprudence in this area will take now that both of those voices are silent.

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