The Importance of Being Interest: Why a State Cannot Impose its Income Tax on Tribal Bonds

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INTRODUCTION

Known colloquially as a “muni,” a municipal bond is issued by a state or local government as a way of borrowing money. The issuing governmental entity pays interest on the bond principal to the bond owner. If the bond meets certain federal requirements, then the interest income that the bond owner receives is excluded from gross income and, as a result, is not subject to the federal income tax. This exemption from the federal income tax is an important feature of the bond because investors are

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1 See John Downes & Jordan E. Goodman, DICTIONARY OF FINANCE AND INVESTMENT TERMS 439 (7th ed. 2006).
2 A bond may be issued with no interest or at a rate of interest that is too low for the market. These bonds are issued at a discount. This original issue discount is a form of unstated interest. For example, a $100,000 bond may be issued at no interest payable in one year. An investor may be willing to pay $96,000 for such a bond and then collect $100,000 on the date of its maturity one year from issue. Such a bond has original issue discount of $4,000, which, in effect, is $4,000 of unstated interest. See Calvin H. Johnson, A Thermometer for the Tax System: The Overall Health of the Tax System as Measured by Implicit Tax, 56 SMU L. REV. 41, n. 43 (2003). The municipal bond market, however, usually involves bonds that mature a substantial number of years in the future. As a result, the stated interest rate is usually close to the actual interest rate when taking original issue discount into account.
3 For general revenue bonds of state and local governments, the requirements involve arbitrage restrictions and registration requirements. See I.R.C. §§ 148 & 149 (2008).
4 See I.R.C. § 103(a).
5 See id. In addition, state and local governments also issue private activity bonds used to fund private projects of governmental interest. These bonds are subject to more rules and restrictions. See I.R.C. §§ 141 – 147 (2008).
willing to accept a lower interest rate on a municipal bond than on a bond whose interest is fully taxable. The bond owner looks at the after-tax yield as an important factor in determining if the municipal bond is a good investment.

For example, suppose T, an individual investor who is in the 30% federal income tax bracket, has a choice between a $100,000 New York City municipal bond paying 8% interest per year for 20 years or a $100,000 General Electric (GE) bond paying 10% interest per year for 20 years. The municipal bond pays $8,000 interest per year, and the GE bond pays $10,000 per year. Assuming equivalent credit worthiness for the two borrowers and ignoring the federal income tax consequences, then the GE bond provides T with $2,000 more in interest income and, therefore, generates a better yield. But once we factor in the federal income tax, the difference in after-tax yield for the two bonds shows that the municipal bond is T’s better investment. T would pay no federal income tax on the $8,000 in interest from the municipal bond but would have to pay $3,000 in federal income tax on the $10,000 in interest from the GE bond (interest of $10,000 x 30% federal income tax rate = $3,000 in federal income tax). T’s after-tax yield on the GE bond would be $7,000 per year ($10,000 in interest less $3,000 in federal income tax). The after-tax yield for the GE bond is 7% compared to the 8% yield on the municipal bond. All things considered, then, the municipal bond is the better investment for T and provides $1,000 more in after-tax income than the GE bond.

This federal tax exemption operates as an indirect federal subsidy to state and local governments. If the federal government foregoes income tax revenue on the interest income that a municipal bond generates, then state and local governments can pay lower rates of interest on the money they borrow. The above example illustrates how this works: the investor gets a better after-tax rate of return, the city pays a lower rate of interest, and the federal government does not collect any federal income tax on the interest income that T earns from the municipal bond. The magnitude of this indirect federal subsidy, which is known as a tax expenditure, is approximately $35 billion per year for the period 2006 to 2012.

In 1983 Congress decided that federally recognized Indian tribes, which have many of the infrastructure needs of state and local governments, should enjoy a

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7 See id. But see Johnson, supra note 2, at 23-24 (arguing that the investor, not the state or local government, is capturing most of the tax subsidy by receiving higher yields than one would expect taking into account the tax-exempt status of the interest income).
8 See Johnson, supra note 2, at 39 (arguing that bonds issued by the federal government should be used in making comparisons because the level of risk is similar).
10 See id. at 148.
comparable federal income tax exemption for their tribal bonds.\textsuperscript{12} Congress made the assumption that federal tax-exempt status for tribal bonds would lower the borrowing costs of tribes in the same way that it does for state and local governments.\textsuperscript{13} The lower costs of borrowing for tribes would free up more money for tribal projects. For example, if the Navajo Nation issued tribal bonds at 7% interest and if an individual investor bought one of these bonds with a principal of $100,000, then the bond owner’s annual interest of $7,000 would not be subject to the federal income tax because of the rule that excludes the $7,000 from gross income.\textsuperscript{14}

This is a thumbnail sketch of the federal income taxation of interest paid on bonds issued by state, local, and tribal governments. State income taxation of interest on a municipal bond is a little different. States, like the federal government,\textsuperscript{15} have the power to tax,\textsuperscript{16} and most states have an income tax.\textsuperscript{17} State income tax rates tend to be much lower than the federal rates.\textsuperscript{18} Therefore, the question of state income tax exemption for interest on state, local, and tribal bonds involves a lower order of magnitude than the federal exemption.\textsuperscript{19} Nonetheless, all the states with an income tax, except Indiana,\textsuperscript{20} have enacted legislation that extends the exemption only to their own bonds.\textsuperscript{21} As a result, almost all the states with an income tax impose their tax on interest earned on out-of-state bonds.

This in-state preference annoyed two taxpayers from Kentucky.\textsuperscript{22} George and Catherine Davis owned some out-of-state municipal bonds that paid them interest,\textsuperscript{23} and Kentucky imposed its income tax on this interest income.\textsuperscript{24} The taxpayers challenged the state’s power to discriminate in favor of in-state bonds.\textsuperscript{25} The taxpayers asserted that

\textsuperscript{13} See Aprill, supra note ___, at 343, n. 57 (summarizing congressional testimony indicating need for tax-exempt bonds).
\textsuperscript{14} See id. at 348 (criticizing Congress for not allowing tribes to issue private activity bonds because tribes generally lack the tax base that is necessary to issue general revenue bonds).
\textsuperscript{15} The United States Constitution grants Congress the power to tax. U.S. CONST. art. I, § 8, cl. 1.
\textsuperscript{16} See THE FEDERALIST NO. 32, at 194 (Alexander Hamilton) (Edward Mead Earle ed., 1976) (noting that the proposed constitution, with the exception of duties on imports and exports, allowed the states to retain their power to tax “in the most absolute and unqualified sense”).
\textsuperscript{19} See I.R.C. § 1(i) (2008) (providing a top marginal tax rate of 35% on federal taxable income of individuals).
\textsuperscript{20} Indiana is the only state with an income tax that provides an exemption for all state and local bonds. See IND. CODE § 6-3-1-3.5 (2008). Utah provides an exemption for state and local out-of-state bonds if the sister state exempts Utah bonds. See UTAH CODE ANN. § 59-10-114(1)(g) & (6) (2008).
\textsuperscript{21} See Dep’t of Rev. of Ky. v. Davis, 553 U.S. ___, ___ n. 6 (2008).
\textsuperscript{22} Id. at ___.
\textsuperscript{23} Id. at ___.
\textsuperscript{24} Id. at ___.
\textsuperscript{25} Id. at __.
Kentucky’s discriminatory form of taxation violated the dormant commerce clause of the United States Constitution. The text of the Constitution merely grants Congress the power to “regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” The United States Supreme Court, however, has interpreted the commerce clause text as having a negative implication in instances when Congress has not undertaken any direct regulation. Now referred to as the dormant commerce clause, the Court’s body of case law provides a broad prohibition against state laws that discriminate against interstate commerce. Over the years, the Court’s dormant commerce clause jurisprudence has developed some refinements, including an exception for state or local laws that further a legitimate governmental interest apart from economic protectionism.

In the Kentucky case, the Supreme Court concluded that the public finance needs of state and local governments justified the state’s income tax discrimination in favor of its own state and local bonds. Accordingly, the state income tax on the interest of out-of-state municipal bonds did not violate the dormant commerce clause and was, therefore, constitutional. The Davis case did not involve the state income taxation of tribal bonds. Consequently, a state’s power to tax interest on tribal bonds remains an open question for those 42 states with an income tax and an exemption limited to in-state bonds. None of these 42 states has an explicit provision dealing with interest on tribal bonds. Certainly, some states will assert that their income tax applies to interest their residents earn on tribal bonds. An added variable is that some states have tribes within their boundaries, making these tribal bonds arguably the equivalent to in-state bonds.

In this article, I use the Davis case as the point of departure for a critical analytical discussion of a state’s power to impose its income tax on tribal bond interest. In general, I conclude that states do not have the power to tax this interest for three independent reasons. First, the federal regulation of tribal bonds is so pervasive that it preempts state taxation under the Indian preemption doctrine. Second, state taxation of tribal bond interest adversely affects tribal resources and, therefore, impairs and infringes tribal sovereignty so substantially that the state power to tax is rendered invalid. Finally, the Indian commerce clause, as interpreted by the United States Supreme Court, prohibits discriminatory state taxation when it involves transactions so closely connected to tribes and to Indian country. These three independent barriers to state income taxation of tribal bond interest apply whether the tribe issuing the bond is located within the state or in

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26 Id. at ___.
27 U.S. CONST. art. I, § 8, cl. 3.
28 See Davis, 553 U.S. at [7].
29 See id. at [7].
30 See id. at [8].
31 See id.
32 See id. at [11].
33 For a list of these states, see id. at fn. 6.
34 See Gail Hall, Analysis of Original Bill (SB 995): Exemption/Interest On Bonds Issued By Federally Recognized Indian Tribal Government Located Within This State (Franchise Tax Board, Feb. 22, 2005), http://www.ftb.ca.gov/law/legis/05_06bills/sb995_022205.pdf (copy on file with author) (providing an analysis of a proposed bill to grant tax exemption for purposes of the California income tax for interest earned by California taxpayers owning a tribal bond issued by a federally recognized Indian tribe located within California). California never amended its income tax law to provide an exemption for interest earned on tribal bonds.
another state. Arguably, denial of an exemption for interest from a tribal bond issued by a tribe within a state violates the equal protection clause of the 14th amendment because it is based on a racial category that does not survive strict scrutiny. I conclude, however, that federally recognized Indian tribes are distinct political entities under our constitutional framework and that their special status is political, not racial. Accordingly, states, based on revenue needs and their legitimate interest in funding their own governmental projects, have a rational purpose sufficient to survive 14th amendment scrutiny under the equal protection clause.

In order to provide the fullest consideration of these very complicated issues, I have divided my discussion into six parts. In the first part, I discuss specific state statutes to show how their application to the state income taxation of interest on tribal bonds is textually unclear. The primary purpose of this part of the discussion is to show that the analysis must start with the particular state income tax statute itself to see if it purports to tax the interest income generated by a tribal bond. In some instances, the more reasonable interpretation of the state statute may lead to the conclusion that the statute does not impose a tax on the interest from the tribal bond. None of the relevant statutes contains an explicit exemption for tribal bonds, although California has proposed one that it has yet to adopt.35

In part II, I explore the special treatment of federally recognized Indian tribes and the broad exemption they enjoy from state taxation when the legal incidence of a state tax falls on the tribe for activities that take place wholly or primarily within the tribe’s reservation. I conclude that the legal incidence of the state income tax falls on the bond owner, not the tribe. As a result, tribal immunity from state taxation does not extend to the interest it pays on tribal bonds and, therefore, this immunity, by itself does not bar state income taxation of the interest from the tribal bond. In part III, I investigate the application of the Indian preemption doctrine and conclude that the federal statutes, regulations, and administrative authority dealing with tribal bonds so occupy the field that the state’s power to tax tribal bond interest is preempted. The discussion in part IV explores whether a state income tax on tribal bond interest impermissibly infringes tribal sovereignty. The current Supreme Court has paid little attention to state infringement of tribal sovereignty and needs to develop meaningful standards for limiting state encroachment on tribal sovereignty. A state taxing power is a good starting place, especially when this power directly impedes a tribe in its exercise of an essential governmental function. In part V, I discuss application of the Indian commerce clause. Supreme Court jurisprudence is in its infancy on this question and should expand to impose a constitutional barrier against states whose taxes discriminate against tribes. Finally, in part VI, I discuss whether states that discriminate against tribes within their borders are engaging in unconstitutional racial discrimination. I conclude that the discrimination is political, not racial, and, therefore, does not violate the 14th amendment.

I. ANALYTICAL BEGINNING

When dealing with state taxation of transactions involving Indian Country, the analysis should always start with the state statute and other sources of state law. This analytical beginning insures that the best answers to state law questions come from the

35 See id.
state law itself. The administration of state tax law is in the hands of state tax administrators. If their state’s tax law, regulations, constitution, or administrative interpretations provide an answer that is favorable to the taxpayer, then reliance on federal law becomes unnecessary. Moreover, federal law, especially federal Indian law, is often unfamiliar to the state tax administrator. As a matter of human nature, a state official does not like being told that state law is invalid because of federal law. If there is room for argument, then the state tax administrator may, by nature, adopt the opposing point of view. In contrast, if the source of law is state law, then the state tax administrator is more likely to accept it as a rationale for not taxing the interest on a tribal bond.

In the case of interest from tribal bonds, the text of each individual state income tax statute requires close reading. Of the 50 states, 41 have an income tax.\textsuperscript{36} The District of Columbia also has an income tax.\textsuperscript{37} Of these 42 jurisdictions (41 states + DC), only Indiana has a provision that allows an exemption from its income tax for interest on bonds from Indiana and from all other states.\textsuperscript{38} And even in Indiana’s case, the exemption is by no means explicit as applied to tribal bonds. Instead, the Indiana exemption requires application of a state statute that refers to the Internal Revenue Code,\textsuperscript{39} arguably the most complicated statute ever written. If someone had to explain Indiana’s income tax exemption for interest on tribal bonds by reference to a specific statute, it would be difficult. Instead, the exemption in Indiana arises because its state income tax adopts federal adjusted gross income as the starting point for its tax.\textsuperscript{40} The Indiana modifications to this definition do not require an adjustment for interest income earned on out-of-state bonds or on tribal bonds.\textsuperscript{41} Federal adjusted gross income under the federal income tax does not include interest on state and local bonds.\textsuperscript{42} Certain tribal bonds are defined as state and local bonds for federal income tax purposes.\textsuperscript{43} As a result, the income from these tribal bonds is not included in federal adjusted gross income and, accordingly, is not part of income for purposes of Indiana’s state income tax.\textsuperscript{44}

Most of the other states with an income tax initially define income as does Indiana by reference to federal adjusted gross income or taxable income.\textsuperscript{45} These states,


\textsuperscript{37} See D.C. CODE § 47-1806.01 (2008).

\textsuperscript{38} Actually, the Indiana income tax defines its tax base as the federal adjusted gross income of the taxpayer with no adjustments for the federal exclusion for interest on state, local and tribal bonds. As a result, the federal exclusion is incorporated into Indiana’s definition of its tax base. See IND. CODE § 6-3-1-3.5 (2008). See also Dep’t of Revenue of Kentucky v. Davis, 553 U.S. ___, n. 7 (2008).


\textsuperscript{40} See IND. CODE § 6-3-1-3.5 (2008).

\textsuperscript{41} See id.

\textsuperscript{42} I.R.C. § 103(a) (2008).


\textsuperscript{44} See Scott A. Taylor, An Introduction and Overview of Taxation and Indian Gaming, 29 ARIZ. ST. L. J. 251, 260 (1997).

however, then make certain additions to income,\textsuperscript{46} including interest on state and local bonds from other states.\textsuperscript{47} This addition has the effect of removing the exemption and subjecting the interest income from out-of-state bonds to the in-state income tax.

Kentucky, which was the state involved in the \textit{Davis} case, is a good example of how this works. Kentucky defines its “adjusted gross income” as federal adjusted gross income subject to Kentucky’s own list of subtractions and additions.\textsuperscript{48} One of these additions is “interest income derived from obligations of sister states and political subdivisions thereof.”\textsuperscript{49} Kentucky’s adjusted gross income is further reduced by deductions to arrive at “net income,”\textsuperscript{50} which is then the tax base on which Kentucky’s income tax is applied. The effect is to preserve the exemption for interest on in-state bonds while removing the exemption for out-of-state bonds. What about tribal bonds?

The text of the Kentucky statute is “obligations of sister states and political subdivisions thereof.”\textsuperscript{51} This language makes no specific reference to tribal bonds. As a result, a Kentucky taxpayer who owns a $100,000 Navajo Nation bond earning $7,000 in interest each year legitimately could argue that this $7,000 of interest income is exempt from the Kentucky income tax. The taxpayer’s argument is fairly logical. The federal income tax defines a tribal bond as being a state or local bond.\textsuperscript{52} The federal statute that excludes municipal bond interest income from the bond owner’s federal gross income also excludes the interest income from the Navajo bond because it is treated the same as a state or local bond for federal income tax purposes.\textsuperscript{53} As a result, the Navajo bond owner’s federal adjusted gross income does not include the interest from the Navajo bond. Kentucky’s definition of its adjusted gross income incorporates the federal definition of adjusted gross income.\textsuperscript{54} The Kentucky adjustment that adds municipal bond interest back into Kentucky adjusted gross income extends only to an “obligation of a sister state.”\textsuperscript{55} If the Navajo Nation is not a sister state, then the Navajo Nation bond is not an “obligation of a sister state” for purposes of the Kentucky statute. Accordingly, the interest income paid to the Kentucky taxpayer who owns the Navajo bond need not be added back into Kentucky adjusted gross income under this line of argument.

Kentucky, however, may very well argue that the Navajo Nation is a sister state under its statute. If Kentucky takes this position, then the question becomes whether a federally recognized Indian tribe is a “sister state” for purposes of the Kentucky statute. The Kentucky statute itself provides no definition of “sister state” or Indian tribe. The state tax authorities in Kentucky are working on a pretty clean slate. And the state courts would not have much to go on. Therefore, Kentucky might turn to federal law for guidance. The most relevant place to start would be section 7871(a)(4) in the Internal

\footnotesize{\textsuperscript{46} See, e.g., MINN. STAT. § 290.01(19) (2008) (defining Minnesota net income as federal taxable income as defined in I.R.C. § 63).
\textsuperscript{47} See, e.g., MINN. STAT. § 290.01(19a)(1)(i) (2008) (adding “interest income on obligations of any state other than Minnesota” that is otherwise exempt under federal income tax law).
\textsuperscript{48} See KY. REV. STAT. ANN. § 141.010(10) (West 2008).
\textsuperscript{49} See id at § 141.010(10)(c).
\textsuperscript{50} See id. at § 141.010(11).
\textsuperscript{51} See id at § 141.010(10)(c).
\textsuperscript{52} See I.R.C. § 7871(a)(4).
\textsuperscript{53} See I.R.C. § 103(a).
\textsuperscript{54} See KY. REV. STAT. ANN. § 141.010(10) (West 2008).
\textsuperscript{55} See id. at § 1.41.010(10)(c).}
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Revenue Code. This section treats tribal bonds the same as state and local bonds by saying that an “Indian tribal government shall be treated as a State … for purposes of section 103 (relating to State and local bonds).” Section 103 of the Internal Revenue Code provides the exclusion from gross income for interest earned on state and local bonds. And it is the effect of section 103 that caused Kentucky to require the addition of interest from bonds of sister states. Whether these federal statutes are sufficient to transform the Navajo Nation into a sister state for purposes of the Kentucky statute is entirely unclear. The federal statute, however, does provide Kentucky with an argument that the Navajo Nation should be treated the same as other states, at least for this limited purpose of imposing Kentucky’s income tax. Ultimately, Kentucky tax authorities have the initial responsibility for interpreting Kentucky tax law. My guess is that they will treat the Navajo Nation bond the same as a bond from New York.

A number of other states use language similar to Kentucky’s statute, which starts with the federal definition of taxable income but then adds back interest earned on out-of-state bonds. New York and North Dakota are good examples. New York’s add-back language applies to “interest income on obligations of any state other than this state…” The add-back language is limited to states (and their political subdivisions); therefore, it arguably does not extend to tribes. North Dakota adopts similar language but actually adds back all interest from all states but then excludes obligations of North Dakota. For states with statutes like Kentucky, New York, or North Dakota, the state income taxation of interest on tribal bonds is unclear and requires statutory interpretation.

Other states follow the Kentucky approach but use substantially different language in defining the bonds whose interest is subject to taxation. Arizona is a good example. Its statute applies to “obligations of any state, territory or possession of the United States, or any political subdivision thereof, located outside the state of Arizona.” The Arizona language is more expansive and applies to territories and possessions of the United States together with their political subdivisions. This language could extend to Indian tribes if they are viewed as territories or possessions of the United States. Arizona case law suggests that the state courts do not view tribes as territories or possessions. Other states, in other legal contexts, have viewed tribes as having the same legal status as a territory. This ambiguity in the statutory language means that the treatment of interest on tribal bonds is unclear. An additional complication in the Arizona language is that it could be construed as allowing an exemption for tribes located within Arizona. Arizona has federally recognized tribes wholly or partly within its boundaries. Accordingly, the “outside the state of Arizona” language may mean that only those tribes outside of the state are covered by the special provision.

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57 Kentucky has no federally recognized Indian tribes within its borders. Therefore, consideration of the treatment of in-state tribal bonds for Kentucky is irrelevant.
59 See N.D. CENT. CODE § 57-38-01.2(1)(g) (2008) (“provided, that interest upon obligations of the state of North Dakota or any of its political subdivisions shall not be included”).
60 See ARIZ. REV. STAT. ANN. § 43-1021(3) (2008).
62 See id. at 361-62.
The statutory rules for Arkansas provide a clear case in which the state income tax will apply to interest paid on tribal bonds. Gross income is broadly defined and includes interest income. Specifically excluded from gross income is any interest earned on “obligations of the State of Arkansas or any political subdivision” under this statutory framework, interest on a tribal bond is included within the generic definition of “interest” but not subject to a specific exclusion that applies only to in-state bonds. Accordingly, the tribal interest would be subject to the Arkansas income tax. Alabama uses a statutory approach that is similar to Arkansas relying first on a broad rule of inclusion and then providing a narrow rule of exclusion for in-state bonds.

Colorado takes yet another approach. Starting with the federal definition of taxable income, it adds back all interest income excluded by federal law except for interest earned on in-state bonds. This approach clearly subjects interest on tribal bonds to the Colorado income tax. Those states following the Colorado approach include Delaware, Georgia, and Idaho.

The important point here is that the precise language varies for each state statute dealing with the income tax treatment of interest on bonds exempt under the Internal Revenue Code. In some states, the taxpayer has a good argument that the text of the state income tax law actually exempts interest on tribal bonds. In other states, the text seems clear and extends taxation to tribal bonds. Taxpayers who own tribal bonds should carefully read the state statute dealing with their state’s income taxation of interest on bonds that are exempt from the federal income tax.

II. STATE TAXATION OF FEDERALLY RECOGNIZED INDIAN TRIBES

As a general proposition, states cannot tax tribes for activities that tribes undertake within their own reservations. If a tribe engages in activity off its reservation, then a state is free to tax that activity unless Congress restricts the state power. In addition, a state can tax a non-member, non-Indian on transactions on or off the reservation involving a tribe or its members unless Congress restricts the state power. These three rules seem relatively simple. Unfortunately, their application is...
often difficult because deciding on whom the tax falls is difficult\textsuperscript{74} and locating the transactions on or off the reservation depends on all the facts and circumstances.\textsuperscript{75} In addition, Congress rarely provides an explicit rule preempts state taxation.\textsuperscript{76}

\textbf{A. Tribal Immunity from State Taxation}

The United States Supreme Court has recognized that a tribe is immune from state taxation for activities undertaken within its own reservation. The Court first acknowledged\textsuperscript{77} this principle of immunity in 1973 when it decided \textit{Mescalero Apache Tribe v. Jones}.

\textbf{78} The issue in \textit{Mescalero} was New Mexico’s power to impose its gross receipts tax on the tribe’s sale of goods and services\textsuperscript{79} in connection with the operation of a ski resort located just outside the reservation boundary.\textsuperscript{80} The Court permitted the imposition of the state tax because the activity was located off the reservation\textsuperscript{81} and because no federal statute restricted the state’s power to tax.\textsuperscript{82}

The Court’s opinion, written by Justice White, said virtually nothing about the underlying basis of the general principle that a tribe is immune from state taxation on activity within its reservation.\textsuperscript{83} Instead, Justice White spent considerable time rejecting

\begin{itemize}
  \item \textit{See Central Machinery Co. v. Arizona State Tax Comm’n}, 448 U.S. 160, 164-65 (1980) (finding that a sale to a tribe by a non-resident, non-Indian vendor was preempted by the federal Indian Trader Statute because the transaction was primarily located within the reservation). Justice Stewart’s dissent in \textit{Central Machinery} shows that a minority of the Court believed that the business location of the vendor was an important factor that should have allowed the state to impose a tax on the transaction. \textit{Id.} at 169-170.
  \item \textit{See id.} at 146-47.
  \item \textit{See id.} at 146.
  \item \textit{See id.} at 148-49.
  \item \textit{See id.}
  \item \textit{See id.} at 148.
\end{itemize}
the theory that a tribe is an instrumentality of the federal government.\textsuperscript{84} Under this theory, the tribe would have enjoyed immunity from state taxation whether its activity was on or off the reservation.\textsuperscript{85} The only whiff of a rationale that Justice White offered was his citation to \textit{McClanahan v. Arizona State Tax Commission}.\textsuperscript{86} Justice White’s reliance on \textit{McClanahan} was entirely misplaced because that case did not involve state taxation of the tribe. He failed to see and recognize that members of the tribe are individuals who are distinct from the tribe, which is a political entity. He has left us with a rule devoid of a rationale. The dissent of Justice Douglas in \textit{Mescalero} added nothing to the rationale justifying on-reservation immunity for the tribe.\textsuperscript{87}

The Court did not address a tribe’s immunity from state taxation again until 1995 in \textit{Oklahoma Tax Commission v. Chickasaw Nation}.\textsuperscript{88} The case involved Oklahoma’s attempt to impose its state tax on motor fuels sold on the reservation at a gas station owned and operated by the Chickasaw Nation.\textsuperscript{89} Justice Ginsburg wrote the opinion for the Court and merely stated that existing Supreme Court case law\textsuperscript{90} required a categorical approach to state taxation of the tribe, which meant that Oklahoma could not impose its tax on gasoline sold by the Chickasaw Nation at its gas station located on its reservation.\textsuperscript{91} Oklahoma had urged unsuccessfully that the Court should balance the federal, state, and tribal interests before deciding whether the state tax was justified.\textsuperscript{92} Justice Ginsburg’s opinion provided no underlying rationale for the Chickasaw Nation’s immunity. She merely observed that the immunity is a preexisting condition that Congress can modify.\textsuperscript{93}

Justice Ginsburg did add one refinement to the analysis: legal incidence. I discuss legal incidence more fully in the next section. The point here, after Justice Ginsburg’s refinement, is that a tribe is not immune from a state tax unless its legal incidence falls on the tribe. For purposes of a tribe’s immunity from state taxation, the economic incidence or burden of the tax is no longer relevant. A tribe enjoys immunity from the state tax

\textsuperscript{84} See id. at 150-55.
\textsuperscript{85} See id. at 150 (rejecting the assertion that the ski resort was a federal instrumentality and immune from state taxation even though it was located off the reservation).
\textsuperscript{86} See id. at 148 (observing that the McClanahan case “lays to rest any doubt in this respect by holding that [state taxation of Indian lands or income] … is not permissible absent congressional consent.”). \textit{McClanahan v. Arizona State Tax Commission}, 411 U.S. 164 (1973), was decided the same day as \textit{Mescalero} and involved Arizona’s attempt to impose its income tax on a member of the Navajo Nation who lived on the reservation and who worked for the tribe. \textit{Id.} at 165-66.
\textsuperscript{87} See \textit{Mescalero Apache Tribe}, 411 U.S. at 159-63 (arguing that the federal legislation permitting the tribe’s building of the ski resort preempted the state’s power to tax).
\textsuperscript{88} See 515 U.S. 450 (1995).
\textsuperscript{89} See id. at 452-53. The case also involved the question of whether Oklahoma could impose its income tax on tribal members who worked for the tribe but who lived off the reservation. On this issue, the Court held in favor of Oklahoma. See id. at 462-67.
\textsuperscript{90} See id. at 458 (Justice Ginsburg citing two cases to support her conclusion that a tribe is immune from state taxation [Bryan v. Itasca County, 426 U.S. 373 (1976) and McClanahan v. Arizona State Tax Commission, 411 U.S. 164 (1973)] even though both cases dealt with state taxation of individual tribal members). Justice Ginsburg, like Justice White, seems to equate tribal members with the political entity of the tribe.
\textsuperscript{92} See id. at 457-58.
\textsuperscript{93} See id. at 458.
only if the legal incidence of the tax falls on the tribe.\textsuperscript{94} The legal incidence refinement that Justice Ginsburg added to the mix provides no help in understanding the rationale behind the general rule. Instead, the rule is now just more complicated: a tribe is immune from state taxation when the legal incidence of the tax falls on the tribe and when the activity takes place on the reservation, unless Congress otherwise authorizes the tax.

The first United States Supreme Court case in which a state was permitted to tax a tribe was \textit{Cass County v. Leech Lake Band of Chippewa Indians}.\textsuperscript{95} In \textit{Leech Lake}, a large percentage of the lands within the tribe’s reservation had been allotted and sold to non-Indians during the late nineteenth and early twentieth centuries.\textsuperscript{96} During the 1980s, the Leech Lake Band began buying private lands within its reservation when these lands went up for sale.\textsuperscript{97} In the early 1990s, Cass County began imposing its property tax on these parcels. The County argued that Congress had authorized the imposition of the local property tax through various federal statutes.\textsuperscript{98} The Court, in an opinion written by Justice Thomas, concluded that the County was correct.\textsuperscript{99} His reasoning reaffirmed the requirement that state taxation of tribal lands was permitted only if Congress had made its intention to permit such taxation “unmistakably clear.”\textsuperscript{100} Justice Thomas articulated the appropriate standard, but he failed to see that Congress did not authorize state property taxation within the narrow facts of this case when the Leech Lake Band owned the land within its own reservation boundaries.\textsuperscript{101} In any case, \textit{Leech Lake} reaffirmed the principle that a state cannot tax a tribe’s reservation lands unless Congress authorizes such taxation in legislation that makes this unmistakably clear. Finally, the opinion provided no rationale for the general rule that a tribe is immune from state taxation for on-reservation activity.

The other Supreme Court case in this area is \textit{City of Sherrill v. Oneida Indian Nation}.\textsuperscript{102} In \textit{City of Sherrill}, local property taxation was once again the issue. In this case, the Oneida Indian Nation purchased properties within the boundaries of the City of Sherrill in New York.\textsuperscript{103} The lands were within the tribe’s 300,000 acre reservation that continues to be the subject of an ongoing land claim in which the Oneida Nation asserts that its title was wrongfully terminated by the State of New York starting in the 1790s in violation of federal law.\textsuperscript{104} The Supreme Court previously confirmed these claims.\textsuperscript{105}

\textsuperscript{94} See id. at 458-59.
\textsuperscript{95} See 524 U.S. 103 (1998).
\textsuperscript{96} See id. at 106. In 1977, the tribe and its members owned only 5\% of the lands within the reservation boundaries. See id. at 108.
\textsuperscript{97} See id. at 108.
\textsuperscript{98} See id. at 109.
\textsuperscript{99} See id. at 113.
\textsuperscript{100} See id. at 110.
\textsuperscript{101} See Scott A. Taylor, \textit{State Property Taxation of Tribal Fee Lands Located Within Reservation Boundaries: Reconsidering County of Yakima v. Confederated Tribes & Bands of the Yakima Indian Nation and Leech Band of Chippewa Indians v. Cass County}, 23 AM. INDIAN L. REV. 55, 92-95 (1998/99) (explaining how Congress has never authorized state taxation of lands owned by a tribe within its own reservation even when tribal ownership is reacquired following a period when the lands were taxable when not owned by the tribe).
\textsuperscript{102} See 544 U.S. 197 (2005).
\textsuperscript{103} See id. at 202.
\textsuperscript{104} See id. at 204-5.
\textsuperscript{105} See id. at 208-9.
The Oneida Nation’s argument in its property tax case was simple. The lands owned by the tribe were located within its historic reservation, and final settlement of those claims was still pending. The Oneida Nation asserted that it should be free from the local property tax unless the City of Sherrill could point to a specific federal statute authorizing the tax. The Court, in an opinion written by Justice Ginsburg, found that the tribe had no immunity because its sovereignty over the lands in question had terminated even though its claims for relief were still very much alive. In substance, Justice Ginsburg relied on a “laches” line of reasoning that essentially penalized the Oneida Nation for not making a timely claim of sovereignty over the disputed lands. Of greater interest for purposes of this article, Justice Ginsburg added nothing to the still blank slate on the rationale for tribal immunity from state taxation.

The Court has had opportunities in these four cases to explain its rationale for tribal tax immunity. The Court has neglected to provide a rationale. Given its next opportunity, the Court should adopt a rationale for its immunity rule. I propose this rationale: State taxation of a federally recognized Indian tribe destroys the tribe’s political integrity and sovereignty which the United States, through treaties, agreements, and legislation, has promised to preserve and to protect. The aboriginal sovereignty of every federally recognized Indian tribe includes immunity from state taxation, which can be imposed only if authorized by treaty, granted through separate consent of the tribe, or allowed by federal legislation.

Justice White, when referring to a tribe’s power to tax, outlined a similar line of reasoning. He said that a tribe’s power to tax “is a fundamental attribute of sovereignty which the tribes retain unless divested of it by federal law or necessary implication of their dependent status.” I would part company with Justice White’s reliance on divestiture through “dependent status” as a means of reducing a tribe’s aboriginal power to tax. Likewise, I would reject “dependent status” as somehow providing a justification for state taxation of a tribe. Instead, the focus should be on explicit authorization from

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106 See id. at 213.
107 See id. at 213-14.
108 See id. at 214 (stating that federal Indian law and federal equity practice “preclude the Tribe from rekindling embers of sovereignty that long ago grew cold.”).
109 See id. at 214-15.
110 Interestingly, Justice Ginsburg describes the Oneida Nation as seeking “declaratory and injunctive relief recognizing its present and future sovereign immunity from local taxation on parcels of land the Tribe purchased”. Id. at 214. The use of the phrase “sovereign immunity” instead of “immunity from taxation” or “tax immunity” suggests that the Oneida Nation at least was making a connection between its sovereign immunity and its immunity from state taxation.
111 See Washington v. Confederated Tribes of the Colville Indian Reservation, 447 U.S. 134, 152 (1980). In terms of the tribe’s power to tax in the Colville case, the Court concluded that such power was not inconsistent with the national power of the United States and, therefore, was not divested by the dependent status of the tribe. For a discussion of “dependent status” and the application of “implicit divestiture,” see John P. LaVelle, Implicit Divestiture Reconsidered: Outtakes from the Cohen's Handbook Cutting-Room Floor, 30 CONN. L. REV. 731 (2006). From a judicial point of view, the United States Supreme Court described tribes as “domestic dependent nations” in Cherokee Nation v. Georgia, 30 U.S. (5 Pet.) 1, 17 (1831) (confirming their political independence but noting that the language of treaties places them under the protection of the United States).
112 Indeed, the opinion of Justice Thomas in Cass County v. Leech Lake Band of Chippewa Indians, 524 U.S. 103 (1998) stated that the intent of Congress to authorize state and local taxation of Indian reservation land must be “unmistakably clear”. See id. at 110.
Congress.\(^\text{113}\) In any case, the core of the rationale for tribal tax immunity should be the preservation of tribal sovereignty.\(^\text{114}\)

B. Tribal Activities “Off” the Reservation

As I discussed in the preceding section, the *Mescalero* case found that “off” reservation activity of a tribe enjoyed no immunity from state taxation unless Congress by legislation limited the state’s power to tax.\(^\text{115}\) In *Mescalero*, placing the activity “off” the reservation was straightforward because the ski resort was located on lands just outside the Mescalero Apache reservation.\(^\text{116}\) Likewise, in locating the gas station owned and operated by the Chickasaw Nation within its reservation was factually uncomplicated.\(^\text{117}\) In many cases, however, placing a transaction “on” or “off” a reservation will be difficult because one transaction may be composed of parts and stages that will have a connection both on and off the reservation.

A good example of this possible difficulty is *Central Machinery Co. v. Arizona State Tax Commission*.\(^\text{118}\) Although *Central Machinery* involved state taxation of a non-Indian and the preemptive effect of the federal Indian trader statute, the location of the transaction “on” the reservation was critical to the outcome.\(^\text{119}\) The underlying transaction involved Central Machinery’s sale of equipment to the Gila River Indian Community.\(^\text{120}\) Central Machinery was located off the reservation, but its salesman solicited the sale on the reservation.\(^\text{121}\) In addition, the signing of the contract, the payment, and the delivery all took place on the reservation.\(^\text{122}\) This led the Court to conclude that the Indian trader statute preempted the Arizona tax.\(^\text{123}\)

In the case of tribal bonds, much of the work will be done both “on” and “off” the reservation. Certainly, the central purpose of the bond issuance is to borrow money to fund governmental projects of the tribe. Accordingly, the physical results of the use of the borrowed funds will be on the reservation (schools, roads, government buildings, water supply projects, waste water treatment facilities). In contrast, the bond underwriter and the bond purchasers probably will be located off the reservation. Locating the bond

\(^{113}\) Even here, I must add that Congress should not unilaterally divest tribe’s of their sovereignty. If Congress authorizes state taxation of tribes, then the sovereignty of tribes diminishes.

\(^{114}\) Two interesting examples of Congress preserving immunity are Public Law 280 and the Indian Gaming Regulatory Act. Public Law 280, which had the effect of shifting criminal jurisdiction within Indian Country from the federal government to enumerated states, specifically provided that “nothing in this section shall authorize...taxation of any real or personal property...belonging to any Indian or Indian tribe”. Act of Aug. 15, 1953, Pub. L. No. 83-280, § 2, 67 Stat. 588, 589 (1953) (codified at 25 U.S.C. § 1162(b) (2008). The Indian Gaming Regulatory Act has a similar provision. This provision states that “nothing in this section shall be interpreted as conferring upon a State...authority to impose any tax...upon an Indian tribe.” Indian Gaming Regulatory Act, Pub. L. No. 100-497, § 11(d)(4), 102 Stat. 2472, 2477 (1988).


\(^{116}\) See *id.* at 146.


\(^{118}\) See *448 U.S. 160* (1980).

\(^{119}\) See *id.* at 165.

\(^{120}\) See *id.* at 161.

\(^{121}\) See *id.*

\(^{122}\) See *id.*

\(^{123}\) See *id.* at 164.
issue “on” or “off” the reservation is not so easy given that Mescalero and Central Machinery are the only cases that have addressed the question.124

C. Legal Incidence

The concept of “legal incidence” of a tax has its practical application primarily in the context of intergovernmental tax immunity. Intergovernmental tax immunity is a constitutional concept whose genesis comes from the early nineteenth century case of McCulloch v. Maryland.125 In McCulloch, the tax issue became constitutional because Justice John Marshall viewed Maryland’s tax on bank notes issued by a federally chartered bank as a state tax on the functioning of the federal government.126 Justice Marshall concluded that such a power could not exist because “the power to tax is the power to destroy,”127 meaning that a state could theoretically destroy the federal government with such a taxing power. Justice Marshall reasoned that the Constitution assumed that the federal government would be immune from state taxation because the states never possessed the power to tax the federal government.128

The federal immunity from state taxation became a reciprocal rule, one providing state immunity from federal taxation, when the United States Supreme Court, in Collector v. Day,129 held that Congress could not impose a federal income tax on the salary of a state judge from Massachusetts.130 In the Day case, the Court assumed that a federal income tax on a state judge’s salary paid by Massachusetts was a tax on Massachusetts because the judge’s state function and his salary were viewed as inseparable.131 The Day case spawned substantial litigation during the 1920s and 1930s under the federal income tax.132 These cases looked at the state’s payment of income to employees and how the imposition of the federal income tax caused an economic burden on the state.133 The United States Supreme Court reconsidered the soundness of its economic burden analysis in 1938 in Helvering v. Gerhardt134 and concluded that the actual burden on the state was not shown and more likely fell on the individual.135 The Court further noted that exemption from the federal income tax produced a windfall for the individual taxpayer with only an insubstantial or speculative benefit for the state.136

126 See id. at 432 (equating the state taxation of the bank’s bonds with state taxation of the U.S. mails, which, according to Justice Marshall, would be inappropriate).
127 See id. at 431.
128 See id. at 430 (concluding that the states never possessed the power to impede federal governmental activity through taxation).
129 78 U.S. (11 Wall.) 113 (1871).
130 Id. at 126.
131 See id. at 122-23.
132 For some of these cases, see Helvering v. Gerhardt, 304 U.S. 405, n. 6 (1938).
133 See id.
134 See id. at 405.
135 See id. at 420.
136 See id.
The next year the Court used the same reasoning to allow state income taxation of a federal employee in *Graves v. New York ex rel. O'Keefe*.137

The concept of legal incidence, as the analytical linchpin in the context of intergovernmental tax immunity, did not reach its full flower, however, until 1982, when the Court, in *United States v. New Mexico*,138 decided that the legal incidence of a tax, and not its economic burden, was the decisive factor in deciding whether the federal government was immune from a state tax.139 In the *New Mexico* case, contractors with the federal government procured goods and service for the benefit of United States, and New Mexico imposed its gross receipts tax on these sales.140 The purchases were paid directly by the federal government under a contractual arrangement with the contractors.141 Clearly, then, the economic burden of these state taxes fell directly on the United States. The Court, however, found that the contractors were not federal instrumentalities142 and that the “legal incidence” of the New Mexico gross receipts tax fell on the contractors143 and not on the United States. Absent from the opinion in the *New Mexico* decision was any discussion of the meaning of the “legal incidence” concept. In summarizing the state of the case law as it addressed the issue in a related case four years earlier, the Tenth Circuit noted that the concept of “legal incidence” had “never been explicitly formulated by the Supreme Court.”144 And the Supreme Court in its *New Mexico* opinion developed the concept of “legal incidence” no further because the United States had conceded that the legal incidence of the New Mexico gross receipts tax fell on the contractors and not on the United States.145

By 1988 the Supreme Court was called upon to consider the federal income taxation of interest on state and local bonds in *South Carolina v. Baker*.146 South Carolina asserted that a federal income tax on the interest of its bonds was a direct tax on the state and therefore unconstitutional under the doctrine of intergovernmental tax immunity.147 The Court rejected this argument and found that the tax, if imposed, would be paid by the bondholders on whom the legal incidence of the tax would fall.148 The Court acknowledged that the state would have to pay a higher interest rate but that this would be an administrative cost, not a tax.149

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137 See 306 U.S. 466, 480 (1939) (the theory that “a tax on income is legally or economically a tax on its source, is no longer tenable.”). See id. at 280.
139 See id. at n. 11 (“With the abandonment of the notion that the economic—as opposed to the legal—incidence of the tax is relevant, it becomes difficult to maintain that federal tax immunity is designed to insulate federal operations from the effect of state taxation.”).
140 See id. at 728.
141 See id.
142 See id. at 735.
143 See id. at 738.
144 United States v. New Mexico, 581 F.2d 803, 806 (10th Cir. 1978) (involving contractors dealing with the federal White Sands Missile Range).
147 See id. at 508.
148 See id. at 526.
149 See id.
In 1995, with the Supreme Court’s decision in Oklahoma Tax Commission v. Chickasaw Nation,\(^{150}\) the “legal incidence” concept became part of the federal case law dealing with tribal immunity from state taxation. In the Chickasaw Nation case, Oklahoma attempted to impose its fuel excise tax on sales of gasoline made by the Chickasaw Nation at its convenience stores located on the reservation.\(^{151}\) Relying on the legal conclusion drawn by the Tenth Circuit, the Supreme Court found that the legal incidence of the Oklahoma fuel excise tax fell on the Chickasaw Nation and not on the wholesaler or the final consumer.\(^{152}\) Oklahoma contested the Tenth Circuit’s conclusion,\(^{153}\) but the Supreme Court felt that the Tenth Circuit’s conclusion had been reasonable.\(^{154}\) Justice Ginsburg, who wrote the opinion for the Supreme Court, hailed the “legal incidence” test as a “bright-line standard” that would aid tax administration.\(^{155}\) Absent from the discussion is any meaningful definition of “legal incidence.” And Justice Ginsburg’s discussion of the issue shows that the Oklahoma statute in question was not clear on legal incidence and that the federal court of appeals was left with the chore of interpreting this state tax statute.\(^{156}\) Finally, Justice Ginsburg noted that “legal incidence” allows a certain amount of flexibility if a state is willing to amend its taxing statute so that the text of the law places the legal incidence of the fuel excise tax on a person other than the tribe.\(^{157}\)

Indeed, Kansas availed itself of this flexibility to insure that the legal incidence of its fuel excise tax would not fall on the tribe. In this way, the tribe would have no tax immunity. In Wagnon v. Prairie Band Potawatomi Nation,\(^{158}\) Kansas wrote its fuel excise tax statute so that the tax would fall on off-reservation wholesalers before delivery to gas stations owned by tribes.\(^{159}\) In this case, the Prairie Band of the Potawatomi Nation owned a gas station operated primarily as a convenience for customers driving to and from the Nation’s casino.\(^{160}\) The Court found that the legal incidence of the fuel excise tax applied to wholesalers off the reservation before they sold their fuel to the gas station of the Nation.\(^{161}\) Accordingly, the Wagnon decision shows that the “legal incidence” test makes the doctrine of intergovernmental immunity essentially meaningless in those cases where the particular government is willing and able to change its tax statute so that the legal incidence shifts to a person who does not enjoy immunity.

Almost all individual income taxes are written in a way so that the individual taxpayer’s income is the subject of the tax for which the individual has final liability of

\(^{151}\) See id. at 455.
\(^{152}\) See id. at 460.
\(^{153}\) See id.
\(^{154}\) See id. at 461.
\(^{155}\) See id. at 460.
\(^{156}\) See id. at 461.
\(^{157}\) See id. at 460.
\(^{158}\) See Prairie Band Potawatomi Nation v. Richards, 379 F.3d 979, 982 (10th Cir. 2004) (indicating that Kansas amended its fuel excise tax statute so that the legal incidence would shift in a way so that it could tax on-reservation sales of gasoline).
\(^{159}\) See Wagnon, 546 U.S. at 99.
\(^{160}\) See id. at 102-3.
payment. Nonetheless, it is common for income tax systems to use withholding at the source so that payers of income are responsible for initial withholding and payment of the income tax. This is true in the United States where employers are responsible for withholding and paying the federal income tax on the wages of their employees. If an employer neglects to withhold and pay, then the employer faces financial liability for non-payment even though the income tax is a personal liability of the employee. Even with this additional legal liability for employers, we still assume that the legal incidence of the federal income tax is on the individual. We make the same assumption for state income taxes.

In the case of interest on bonds, the payer has no obligation to withhold and pay the federal income tax on the interest income earned by the bond owner. However, the bond issuer has an obligation to report to the Internal Revenue Service the amount of interest that it paid to each bond owner. The bond owner, then, has the obligation to report this interest on the income tax form and to pay any resulting federal income tax liability. Before 2006, the issuer of a municipal bond had no obligation to report the amount of interest paid to each bond owner. Now, however, information reporting is required, but the interest income still remains exempt from the federal income tax. For state income tax purposes, states can require in-state issuers to report the interest that they pay to bond owners. However, states cannot require out-of-state issuers of municipal bonds to report interest payments to them. Accordingly, states have no practical way for imposing withholding and payment of their income taxes on interest paid by other state and local governments.

Therefore, for purposes of this article, I will assume that the legal incidence of the state income tax falls on the owner of the tribal bond and not on the tribe. As a result, legal incidence, which can be especially tricky in cases involving sales, use, and excise

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162 See, e.g., I.R.C. §§ 6012(a) (requiring individuals to file federal income tax returns) and 6151 (a) (requiring payment of the tax by the person making and filing the return); Minn. Stat. § 289A.31(1)(a) (2009) (individual income tax “must be paid by the taxpayer upon whom the tax is imposed”); N.M. Stat. §§ 7-2-3 (2009) (imposing an income tax on residents and non-residents [with New Mexico source income] at specified rates) and 7-1-13(B) (requiring the filing of tax returns and the paying of tax).

163 See, e.g., Minn. Stat. § 290.92(2a)(1) (requiring employers to withhold the Minnesota income tax from the wages of employees and to pay this to the state); N.M. Stat. § 7-3-3(A) (requiring employers to withhold the New Mexico income tax from the wages of the employees and to pay this to the state).

164 I.R.C. § 3402(a).
165 I.R.C. § 3403.
166 See I.R.C. § 3406 (requiring backup withholding if the payee of interest does not provide the payer with necessary information sufficient to allow information reporting to IRS). The information reporting requirements for the payment of interest are contained in I.R.C. § 6049.

167 See I.R.C. § 6049.
168 See I.R.C. § 61(a)(4) (defining interest as a form of gross income) and Treas. Reg. 1-61-7(a).

170 See I.R.C. § 103(a).

171 This limitation applies because a state’s jurisdiction and taxing powers over extraterritorial matters are limited to those people and objects that have a nexus with the particular state. See Quill Corp. v. North Dakota, 504 U.S. 298, 312-13 (1992) (holding that North Dakota could not require an out-of-state seller to impose and collect the state’s use tax on sales into the state when the only contact involved mail order sales and no physical presence).

172 See id.
taxes, is not such a troublesome issue here because everyone assumes that the legal incidence of the state income tax falls on the bond owner who receives the interest income. Legal incidence would be relevant only if one tribe owned a bond issued by another tribe. In that case, the legal incidence of the state income tax would fall on the bond owning tribe. Under the tribal immunity cases, a state would be unable to impose its income tax on the interest paid to a tribe within its boundaries. In contrast, a non-tribal owner of a tribal bond would not enjoy tribal immunity because the legal incidence of the state income tax falls on him, her, or it.

III. INDIAN PREEMPTION DOCTRINE

The broad notion of federal preemption of state law derives from the supremacy clause in the United States Constitution. That clause provides that:

This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.\(^{173}\)

The supremacy clause is a necessary working rule for deciding when the federal law displaces or nullifies state law.\(^{174}\) Assuming Congress has the power under the Constitution to pass a particular statute, then that federal statute’s effect on state law becomes a frequent question.

In general, federal preemption is either express or implied.\(^{175}\) Express preemption occurs when the text of a particular federal statute explicitly displaces state law.\(^{176}\) A good example of such preemption is the special rule prohibiting state taxation of treaty fishing rights retained by a federally recognized Indian tribe. This provision states:

Such treaties, and any Executive orders and Acts of Congress under which the rights of any Indian tribe to fish are secured, shall be construed to prohibit (in addition to any other prohibition) the imposition under any law of a State or political subdivision thereof of any tax on any income derived from the exercise of rights to fish secured by such treaty, Executive order, or Act of Congress if section 7873 of title 26 does not permit a like Federal tax to be imposed on such income.\(^{177}\)

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\(^{173}\) U.S. CONST. art. vi.

\(^{174}\) See JOSEPH STORY, 3 COMMENTARIES ON THE CONSTITUTION OF THE UNITED STATES § 1831 (Hilliard, Gray & Co., 1833) (stating that if “it was to establish a national government, that [federal] government ought, to the extent of its powers and rights, to be supreme.”).

\(^{175}\) See, e.g., Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977) (finding that a federal law preempts a state law when "Congress' command is explicitly indicated in the statute's language or implicitly contained in its structure and purpose.").

\(^{176}\) See id.

\(^{177}\) 25 U.S.C. § 71 (2008). By reference this statute incorporates the federal prohibition against federal taxation of tribal fishing rights. The federal prohibition states: Sec. 7873. Income derived by Indians from exercise of fishing rights...
In this statute, we see Congress using broad language that prohibits state taxation of income derived from the exercise of tribal fishing rights. When Congress uses such explicit language prohibiting state taxation, states rarely undertake the effort to tax the activity.\textsuperscript{178} In most instances, however, Congress provides no specific rules governing the preemptive effect of its legislation when such legislation deals with Indian Country. This was the case with the federal income tax treatment of tribal bonds. Congress provided fairly specific rules on the federal income tax treatment of tribal bonds\textsuperscript{179} but provided no explicit prohibition of state income taxation of interest paid to tribal bond holders.

Consequently, we are dealing with a case of implied preemption. Implied preemption is more difficult to determine because we have no explicit language to provide guidance. The federal courts have developed something of a preemption jurisprudence when preemption is of the “implied” variety. The two types are field preemption and conflict preemption.\textsuperscript{180} Field preemption arises when the federal regulatory scheme leaves little or no room for state participation.\textsuperscript{181} Conflict preemption arises when a federal law and a state law lead to different results.\textsuperscript{182}

(a) In general
(1) Income and self-employment taxes
No tax shall be imposed by subtitle A on income derived--
(A) by a member of an Indian tribe directly or through a qualified Indian entity, or
(B) by a qualified Indian entity,
from a fishing rights-related activity of such tribe.
(2) Employment taxes
No tax shall be imposed by subtitle C on remuneration paid for services performed in a fishing rights-related activity of an Indian tribe by a member of such tribe for another member of such tribe or for a qualified Indian entity.

\textsuperscript{178} See lack of reported cases involving this prohibition under 25 U.S.C. § 71 (2008). In contrast, states frequently assert their power to tax even when the activity is on the reservation and involves the tribe or a tribal member. See, e.g., The Kansas Indians, 72 U.S. (5 Wall.) 737 (1867) (county in Kansas attempts to impose property tax on lands owned by Shawnee Indians); Thomas v. Gay, 169 U.S. 264 (1898) (Oklahoma Territory attempts to impose a tax on cattle owned by a non-Indian when the cattle were on reservation lands under a lease with the tribe); Warren Trading Post v. Arizona State Tax Commission, 380 U.S. 685 (1965) (Arizona attempts to impose its sales tax on a federally licensed Indian trader selling goods and services on the Navajo Nation); McClanahan v. State Tax Commission of Arizona, 411 U.S. 164 (1973) (Arizona attempts to impose its income tax on a Navajo woman who lives and works on the Navajo Nation); Bryan v. Itasca County, 426 U.S. 373 (1976) (Minnesota county attempts to impose a property tax on a tribal member’s mobile home located on the Leech Lake Reservation); Oklahoma Tax Commission v. Chickasaw Nation, 515 U.S. 450 (1995) (Oklahoma attempts to impose various taxes on the Chickasaw Nation and its members); Wagnon v. Prairie Band Potawatomi Nation, 546 95 (2005) (Kansas attempts to impose motor fuel taxes on gasoline sold at a station owned by the tribe on its reservation).
\textsuperscript{179} See I.R.C. § 7871(c) & (e).
\textsuperscript{181} See, e.g., Rice v. Santa Fe Elevator Corp., 331 U.S. 218, (1947) (general federal regulation of grain elevators occupied the field anf prevented concurrent state regulation).
preemption, the assumption is that the result flowing from application of the federal law is the one Congress would prefer.\footnote{See id.}

Within the context of federal Indian law, the rules of preemption operate somewhat differently.\footnote{See White Mountain Apache Tribe v. Bracker, 448 U.S. 136, 142 (1980):} Often referred to as “Indian preemption,”\footnote{See Alex Tallchief Skibine, Formalism and Judicial Supremacy in Federal Indian Law, 32 Am. Indian L. Rev. 391, 416-20 (2007/2008) (discussing Indian preemption as a separate form of preemption).} this different approach reflects 1) the continuing importance of tribal sovereignty,\footnote{See David H. Getches, Conquering the Cultural Frontier: The New Subjectivism of the Supreme Court in Indian Law, 84 Calif. L. Rev. 1573, 1607 (1963) (stating that “the unique historical origins of tribal sovereignty make it generally unhelpful to apply to federal enactments regulating Indian tribes those standards of pre-emption that have emerged in other areas of the law.”).} 2) the presence of a third party (the tribe) in which there is a special federal interest as shown in treaties, executive orders, and substantial federal legislation and regulation,\footnote{See McClanahan v. Arizona State Tax Comm’n, 411 U.S. 164, 173-74 (1973) (emphasizing the importance of treaties and federal legislation).} and 3) the absence of a seat at the political table for the tribes.\footnote{See Taylor, supra note ___ at 886-90 [Michigan State] (emphasizing how the political framework of Congress adequately protects state interests but does not protect or incorporate tribal interests).} The Supreme Court, as is so often the case with its jurisprudence in most areas of law, has failed to refine Indian preemption into a coherent, logical whole.\footnote{See Skibine, supra note ___, at 416-20.} Instead, Indian preemption may be summarized as a process in which the Court considers and balances the various tribal, federal, and state interests.\footnote{See id.} As a result, Indian preemption may adversely affect state law under circumstances when traditional preemption would not. Therefore, it is important to review Indian preemption to see when and how the interest balancing process comes into play as an overlay to the implied preemption discussed above.

The story of Indian preemption begins with the 1832 case of Worcester v. Georgia.\footnote{See Worcester, 31 U.S. (6 Pet.) 515 (1832).} In that case, Justice John Marshall articulated the proposition that state laws did not extend into Indian Country even if the particular Indian reservation was located solely within a particular state.\footnote{See id. at 561.} The Worcester case was but one episode in a very complicated history in which Georgia, aided and abetted by President Jackson, but not supported by Congress or the Supreme Court, attempted to remove the Cherokee from their homelands in Georgia to territory that later became Oklahoma.\footnote{See ANGIE DEBO, A HISTORY OF THE INDIANS OF THE UNITED STATES 106-07 (1970).} Part of Georgia’s plan to expel the Cherokee to gain access to their lands and the gold thought to be there was a legal regime that required all white people to acquire a license from Georgia before entering the Cherokee Nation.\footnote{See Worcester, 31 U.S. (6 Pet.) at 539-40.} This legislation attempted to isolate the Cherokee from Indian traders and Christian missionaries, many of whom supported the right of the
Cherokee to remain on their lands. Samuel Worcester was a missionary from Vermont whose church received federal funding for its missionary efforts. Worcester undertook missionary activities with federal permission but without obtaining a license under the Georgia statute. Worcester’s failure to secure a license under Georgia law exposed him to criminal liability. When he traveled off of the Cherokee Nation onto Georgia soil, he was arrested, charged, tried, convicted, and imprisoned for violating Georgia law. He appealed his case, which ultimately made its way to the United States Supreme Court. Georgia refused to appear in the case, presumably because it viewed its sovereignty over its own soil as paramount to the Cherokee Nation’s aboriginal title confirmed by federal treaties. Writing for the Court, Justice Marshall concluded that Georgia’s regulations and criminal provisions did not extend into the territory of the Cherokee Nation even though its territory was geographically within the boundaries of Georgia. Reduced to its simplest formulation, the Worcester case essentially held that the presence of a federal-tribal relationship between the United States and the Cherokee Nation, as reflected in treaties and federal legislation, excluded the application of state law. The key point is that the treaties and federal legislation never stated that Georgia law had no application within the Cherokee Nation. Instead, Justice Marshall inferred that the federal presence left no room for Georgia to exert its legislative power. In kernel form, then, the Worcester case expressed an early form of field preemption.

Reality, however, departed from the rule of law. Even though the Supreme Court’s decision in Worcester nullified the state court conviction, Georgia ignored the Court’s ruling and refused to release Samuel Worcester from prison. President Jackson was standing for reelection and needed Georgia’s votes in the Electoral College. In addition, President Jackson had already endorsed a removal policy for the Cherokee Nation and other tribes. Accordingly, he was unwilling to use federal force to free Samuel Worcester from the Georgia prison. Facing a long imprisonment, Samuel Worcester accepted Georgia’s offer to release him from prison if he left Georgia.

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195 See id. at 538.
198 See id. at 537.
199 See id. at 536.
200 See id. at 540.
201 See id. at 536.
202 See id. at 535 (listing no counsel for Georgia and providing no summary of Georgia’s legal position).
203 See id. at 561 (“The Cherokee nation, then, is a distinct community, occupying its own territory, with boundaries accurately described, in which the laws of Georgia can have no force, and which the citizens of Georgia have no right to enter but with the assent of the Cherokees themselves or in conformity with treaties and with acts of Congress.”).
204 See id. (“The act of the State of Georgia under which the plaintiff in error was prosecuted is consequently void, and the judgment a nullity.”).
205 See DEBO, supra note ___, at 105-06.
206 See id.
207 See T. HARRY WILLIAMS ET AL., A HISTORY OF THE UNITED STATES TO 1876, at 370 (1961) (explaining the support that Jackson received from southern states by pursuing a removal policy for Native Americans).
208 See DEBO, supra note ___, at 105-06.
He abandoned his missionary work on the Cherokee Nation in Georgia and moved to the Indian Territory (later Oklahoma) to continue his missionary work with the Cherokee. Ultimately, the Jackson administration negotiated a treaty with the Cherokee Nation in which the tribe agreed to removal to Oklahoma. This treaty, however, was a fraud. The treaty making process between the United States and the Cherokee Nation followed the treaty making formalities but did not include a valid expression of consent from the leaders of the Cherokee Nation. Ultimately, Georgia succeeded in its efforts at ethnic cleansing. The actual removal of the Cherokee was a brutal process in which thousands of Cherokee perished along the now infamous Trail of Tears. Notwithstanding these tragic historical events, the Worcester case remains an important precedent establishing the basic principles of federal preemption.

For our purposes, we can skip forward to 1959 when the United States Supreme Court decided Williams v. Lee, which involved the question of state court jurisdiction over a suit by an Indian trader, Hugh Lee, who sued to collect on a debt incurred by Navajo customers, Paul and Lorena Williams, for the sale of goods. The underlying transaction took place entirely on the Navajo Nation. Even though he could have sued in a Navajo court, Lee sued in the Arizona state court. Relying on Worcester v. Georgia, the Court concluded that state jurisdiction over the lawsuit would infringe the right of the Navajo Nation to govern itself. In the absence of an express authorization from Congress, states, with limited exceptions, have no power over tribes. The William v. Lee case stands for the broad proposition that state law, unless authorized by Congress, cannot infringe tribal sovereignty.

Together, Worcester and Williams v. Lee stand for the proposition that state laws stop at the reservation boundary. For state laws to cross this boundary, Congress must authorize states to exercise judicial and legislative power within Indian Country. The rationale that we extract from Williams v. Lee is that the federal-tribal relationship is intended to protect tribal sovereignty, including possible infringement by the states.

The next important decision is Warren Trading Post v. Arizona Tax State Commission. This case is the primary precedent for federal preemption. In Warren Trading Post, the United States Supreme Court found that treaties, federal legislation, and federal regulations preempted state taxation of licensed Indian traders. No text in these sources of the law specifically mentioned state taxation. Instead, the Court found

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211 See BASS, supra note ___, at 5 (describing how a small group of Cherokee formed the Treaty Party with whom the United States negotiated an illegal treaty).
212 See DEBO, supra note ___, at 106-07.
214 Id. at 217.
215 Id.
216 Id.
217 See id. at 218-19 (discussing the application of Worcester v. Georgia).
218 See id. at 223.
219 See id.
221 See id. at 691-92.
that the federal presence was so pervasive that it left no room for state taxation. This case, then, is a form of simple field preemption.

The infringement concerns expressed in *Williams v. Lee* and the field preemption found in *Warren Trading Post* come together in *White Mountain Apache Tribe v. Bracker*. 222 *Bracker* involved state taxation of non-Indian contractors who hauled harvested timber for the tribe. 223 The Court concluded that infringement and preemption were independent barriers to state taxation. 224 In addition, the Court found that infringement was an important backdrop in determining whether ambiguous federal legislation actually preempted the state power to tax. 225 Finally, the Court considered and weighed the tribal, state, and federal interests. 226 The Court found that the attempts of a state to tax non-Indians required a “particularized inquiry into the nature of the state, federal, and tribal interests at stake.” 227

The Indian preemption doctrine as applied in three subsequent cases is worthy of our attention. The first case is *Cotton Petroleum Corp. v. New Mexico*, 228 a case in which the Court upheld state taxation of oil production on Indian lands by a non-Indian oil company. 229 For our purposes here, the key point in *Cotton Petroleum* is that Congress can authorize state taxation of non-Indians just as it can, explicitly or through implied preemption, state taxation. In *Cotton Petroleum*, the Court found that early federal legislation had authorized state taxation and that subsequent federal legislation did not change this authorization. 230 The Court also explained that, in the absence of federal preemption, states generally can tax non-Indians for their activities within Indian Country. 231 Finally, the Court acknowledged, as part of its preemption analysis, that state taxation could infringe tribal sovereignty and could, therefore, be barred by the infringement test. 232 The Court, however, found that there was no evidence that the state tax actually infringed tribal sovereignty. 233

In the case of *Arizona Department of Revenue v. Blaze Construction Co.*, the reach of federal preemption was narrowed. 234 In *Blaze*, a road construction company entered into road building contracts with the federal government. 235 All the building took place on Indian reservations within the state of Arizona. 236 Blaze Construction Company, the road builder, asserted that various federal statutes preempted Arizona’s taxation of the

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223 See id. at 139.
224 See id. at 143 (“The two barriers [infringement and preemption] are independent because either, standing alone, can be a sufficient basis for holding state law inapplicable to activity undertaken on the reservation or by tribal members.”).
225 See id.
226 See id. at 144.
227 Id. at 145.
229 See id. at 186-87.
230 See id. at 182.
231 See id. at 173-76.
232 See id. at 186-87.
233 See id. at 187.
235 See id.
236 See id. at 34.
construction activity.\textsuperscript{237} The Court, however, held that the company was doing business with the United States, not the Indian tribes.\textsuperscript{238} As a result, the Court found that the federal statutes did not apply to the company and did not preempt state taxation. Likewise, in the case of \textit{Wagnon v. Prairie Band Potawatomi Nation},\textsuperscript{239} the Court undertook a very technical consideration of the preemption cases and concluded that state taxation whose legal incidence is physically located off the reservation does require application of the Indian preemption doctrine.\textsuperscript{240}

Together, these different cases recognize an Indian preemption doctrine in which the tribal, state, and federal interests must be considered in light of the normal preemption rules. Given these cases, the primary question is whether Indian preemption even applies in the context of state income taxation of interest paid on tribal bonds. An application of Justice Thomas’ approach in \textit{Wagnon} could lead to the conclusion that the state income tax on the tribal bond interest is a non-discriminatory state tax that applies to a non-Indian on a transaction that takes place outside of Indian country. In \textit{Wagnon}, Justice Thomas emphasized the “who” and the “where.”\textsuperscript{241} He concluded that a non-Indian was the person subject to a state tax on a transaction taking place off the reservation.\textsuperscript{242} These circumstances, he concluded, took the transaction and the related state taxation outside the scope of the Indian preemption doctrine.\textsuperscript{243} To place this analysis in its proper context, we need to recall that the tax in \textit{Wagnon} was a Kansas fuel excise tax imposed on a non-Indian fuel wholesaler taking delivery of the fuel off the reservation. The tribe bought the gasoline from the wholesaler who then delivered it on the reservation to the tribe and included the Kansas fuel excise tax in the price.\textsuperscript{244} The tribe then sold the gasoline on its reservation mostly to motorists who were on their way to or from the tribe’s nearby casino.\textsuperscript{245} Even though the tribe sold the gas at its own gas station located on the reservation, the tribe was not the taxpayer and the time and place of taxation was not the tribe’s retail sale of gasoline to the final consumer.\textsuperscript{246} According to Justice Thomas, the Indian preemption doctrine did not apply and a consideration of the tribal, federal, and state interests was, therefore, unnecessary.\textsuperscript{247}

Justice Thomas acknowledged that Kansas in the \textit{Wagnon} case had changed its law so that its legal incidence would shift away from the tribe and onto non-Indian wholesalers whose taxable conduct would take place outside of Indian Country.\textsuperscript{248} Justice Ginsburg, in her opinion in Chickasaw Nation ten years earlier, had observed that states could get around tribal immunity from state taxation by changing the legal

\textsuperscript{237} See id. at 37.
\textsuperscript{238} See id.
\textsuperscript{239} 546 U.S. 95 (2005).
\textsuperscript{240} See id. at 101-2.
\textsuperscript{241} See id. at 101.
\textsuperscript{242} See id. at 102.
\textsuperscript{243} See id. at 101-2.
\textsuperscript{244} See id. at 99-100.
\textsuperscript{245} See id. at 99.
\textsuperscript{246} See id. at 102-3.
\textsuperscript{247} See id. at 110 (concluding that the \textit{Bracker} preemption test should not apply when the tax is imposed on a non-Indian outside of the reservation).
\textsuperscript{248} See id. at 105. See also Prairie Band Potawatomi Nation v. Richards, 379 F.3d 979, 982 (10th Cir. 2004) (indicating that Kansas amended its fuel excise tax statute so that the legal incidence would shift in a way so that it could tax on-reservation sales of gasoline).
incidence of their taxes. She did not, however, indicate if this change would necessarily eliminate the need to undertake a preemption analysis. Instead, she conceded that state taxation of tribal interests located off the reservation could be preempted.

In contrast, application of Justice Thurgood Marshall’s approach in Central Machinery Co. v. Arizona State Tax Comm’n would definitely lead to an opposite conclusion. In Central Machinery, Justice Marshall looked at the circumstances and events that made up a transaction that involved the sale of farm machinery to the tribe. Some of the transaction took place off the reservation and part took place on the reservation. All things considered, Justice Marshall concluded that the primary focus of the transaction was on the reservation.

As I noted earlier in the discussion about state taxation in Indian country, the location of the taxable activity as taking place on or off the reservation is a key consideration. Indeed, the results in Central Machinery, Mescalero Apache, and Wagnon hinged on the location of the activity. Implicit in the Court’s analysis is a rather crude notion of boundaries and territoriality that harks back to reservation policies designed to dispossess, dominate, pacify, and isolate Native Americans within confined areas called reservation but which, to be honest, often constituted nineteenth century internment camps. Since 1934 federal policy, with some important lapses, has focused on supporting Indian tribes as political entities retaining some degree of aboriginal sovereignty used to govern their communities and to exercise self-determination. The legal and physical forms of tribes vary tremendously as do their territorial manifestations. Consequently, it seems rather odd that the Supreme Court should draw a line in the sand that corresponds directly with the reservation boundary especially when most aspects of daily life in the United States regularly cross political boundaries of reservation, city, town, county, state, and country.

All the circumstances that make up a single tribal bond transaction are likely to cross all or most of these boundaries. To decide, then, that the state income taxation of the interest that the tribe pays to the bond owner is of no political, jurisdictional, or

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249 See Oklahoma Tax Comm’n v. Chickasaw Nation, 515 U.S. 450, 460 (1995) (noting that “if a State is unable to enforce a tax because the legal incidence of the impost is on Indians or Indian tribes, the State generally is free to amend its law to shift the tax’s legal incidence.”).

250 See id. at 465 (evaluating whether a treaty between the United States and the Chickasaw Nation preempted the Oklahoma income tax on tribal members working for the Nation but living off its reservation).

251 See 448 U.S. 160 (1980).

252 See id. at 161.

253 See id.

254 See id. at 164-65 (focusing on the place where the contract for sale was executed and how the tribe took delivery).

255 See Taylor, supra note ___, at 948 [Marquette].


financial interest to the tribe seems ridiculous. Yet the approach of Justice Thomas in Wagnon is likely to lead to that result because he probably would view the bond owner’s receipt of the interest income and off-reservation residence as sufficient to eliminate any tribal interest. However, the focus of the tribal bond transaction is the financing of a project on the reservation that furthers an essential governmental function of the tribe. Indeed, the tribal bond’s tax-exempt status for federal income tax purposes requires that the bond proceeds be used to further an essential governmental function of the tribe. The transaction itself and the federal income tax treatment that follows show important tribal and federal interests.

Justice Thurgood Marshall’s approach in Central Machinery, even though it proceeded from the assumption that the transaction in question must be located within the tribe’s reservation, was more nuanced than Justice Thomas’ approach in Wagnon. Justice Marshall considered the focus of the Central Machinery transaction in the context of a strong federal interest and a concern for the sovereignty of the tribe. Justice Thomas, in contrast, first located the taxable event off the reservation and then concluded that balancing the respective state, federal, and tribal interests was unnecessary. Justice Marshall, nonetheless, still conceded that the transaction must be “on” the reservation for the preemption analysis to apply. And at this point he focused on facts showing that the place of executing the contract, the place of taking possession, and the place of payment were all on the reservation. Are these really important factors given that imposition of the Arizona’s sales tax will be a financial burden on the tribe purchasing the farm machinery? Is form of payment really that important? Should the preemption of the state tax hinge on whether the payment was hand delivered off the reservation, took place physically on the reservation, or occurred by sending a check through the mail?

So although Justice Marshall’s approach shows more flexibility than the approach of Justice Thomas, both approaches focus on fairly meaningless factors. In this sense, both seem to be conceding that matters of state taxation in Indian country are rather arbitrary and often allow meaningless factors of form ultimately to decide the outcome. I am a law professor who teaches federal income tax and must confess that federal tax law as written, applied, and interpreted often exalts form over substance. Form is important in the federal tax system as a way of promoting clarity and predictability. Nonetheless, substance can and does apply in many circumstances to control questions of taxability in the federal system.

In contrast, the primary purpose of the Indian preemption doctrine is, in the absence of explicit federal guidance, to consider important and competing tribal, federal, and state interests. Consequently, substance should be the overriding concern. It is fair to say that Justice Thomas’ approach in Wagnon exalted form over substance and

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259 See I.R.C. 7871(c)(1) & (e) (2008) (requiring the proceeds of tribal bonds to be used in the exercise of essential governmental functions).

260 See id.

261 See Central Machinery, 448 U.S. at 163-64.

262 See Wagnon, 546 U.S. at 110.

263 See Central Machinery, 448 U.S. at 164-65.

264 See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935) (finding that a purported reorganization that met all statutory requirements was, nonetheless, not a reorganization because it lacked substance) and Rev. Rul. 2002-69, 2002-2 C.B. 760 (stating categorically that the “substance of a transaction, not its form, governs its tax treatment.”).
prevented the Court from considering how the tribe’s gas station and the imposition of the state fuel excise tax played out when tied to the tribal, federal, and state interests.

The categorical “where” in the analysis ought to be abandoned because it focuses too much on form and too little on the substance of the actual taxes. Instead, the Court, in deciding whether to apply Indian preemption, should look at the presence of federal and tribal interests. The most important evidence of a federal interest will be federal legislation. There should be some connection between the federal legislation and the subject matter of the attempted state taxation. The tribal interest will manifest itself most by looking at how the state taxation imposes a financial burden on the tribe and impedes the tribe in its operation as a government. At this point, the “where” question, instead of being one that concludes that the transaction is either “on” or “off” the reservation, should look at the overall transaction and its connection to the tribal, federal, and state interests. Here the transaction can be linked to its function to assist in determining the relative weight to be given to each of the interests.

The “who” question is connected to legal incidence. As I previously discussed, legal incidence means little more than a tax statute naming the taxpayer. In the context of state income taxation of interest on tribal bonds, the legal incidence will fall on the bond owner who most likely will be a person who is not a tribe or a member of a tribe. To bar state income taxation at this point, Indian preemption must come into play. The “who” question, as a result, is unimportant. This takes us back to the “where” question.

Assuming, then, that the interest balancing process should begin, how do the interests fare? It is appropriate to start with the tribal interest because it is the tribe that must carry the financial burden of increased borrowing costs if states are allowed to impose their state income tax on tribal bond interest income. Tribal bond financing of the kind we are discussing involves the funding of projects that further essential governmental functions of the tribe. These projects involve water, sewer, roads, governmental buildings, governmental services, education, health, and other essential functions of government. In general, tribal members living on reservations are among the poorest Americans often lacking the barest necessities of life. Given these social ills, Congress probably believed that tribal bonds, like state and local ones, should enjoy the same exempt status for federal income tax purposes as a way of lessening the cost of borrowing. Because of the great economic needs of tribes and their members, exemption from state income taxation is all the more important. Congress recognized the need to lessen the cost of tribal borrowing. Therefore, state income taxation of tribal bond interest contradicts the federal purpose of lowering the borrowing costs of tribes.

More generally, a core interest of all governments is tax revenue. Without revenue, a government cannot function. Most states raise most of their revenue through taxation. A state’s power to tax, then, is one of its most important governmental powers. Accordingly, Congress and federal courts need to consider any constraints on a state’s taxing power quite carefully. In this article, I assume that Congress has the power to preempt a state’s taxing power if necessary to promote and regulate Indian affairs. So when the tribal interest is strong and where federal legislation promotes that tribal

interest, then the state taxing power should yield. Within a federal system, this result may seem too harsh on the states. However, this is not the case. The states are not irretrievably harmed because Congress, having enacted legislation suggesting that Indian preemption is appropriate, has the power to enact legislation authorizing state taxation.

The Indian Gaming Regulatory Act (IGRA) is a good example of how Congress can respond to situations where the Court interprets federal legislation and its preemptive effect in a way that benefits tribes. Congress passed IGRA in 1988 because the United States Supreme Court had ruled in *California v. Cabazon Band of Mission Indians* that the tribe could operate a high stakes bingo facility on its reservation even though California law made those kinds of bingo games illegal. The Court’s decision, in an opinion by Justice White, found substantial legal ambiguity on the question of the application of California law within Indian Country. Ultimately, the Court found in favor of the tribal interest, upholding the legality of the tribe’s bingo operation.

As a group, states were concerned about the uncontrolled expansion of Indian gaming after the Cabazon decision. Congress responded with IGRA, which gave states a say in Indian gaming and required good faith negotiations between states and tribes. Casino style gaming in most states required the negotiation of a compact between the state and the specific tribe. IGRA gave most of the regulatory authority to the tribes but provided substantial oversight through the National Indian Gaming Commission, a federal agency. IGRA shows that states have the political wherewithal within our constitutional democracy to marshal forces to secure federal legislation if and when they are unhappy with a judicial decision of the Supreme Court. In contrast, tribes do not have political representation in Congress.

Accordingly, the existing federal statutes governing tribal bonds, when considered in light of the competing interests of tribes, states, and the federal government, should preempt state income taxes. If states are unhappy with a judicial decision that confirms this result, then they have ready access to Congress and can argue for remedial legislation as they did after the Court decided the *Cabazon* case.

### IV. INFRINGEMENT OF TRIBAL SOVEREIGNTY

When Indian preemption is involved, state infringement of tribal sovereignty is a factor that the courts consider as part of the process of weighing tribal, federal, and state interests. Infringement became part of the preemption analysis in *McClanahan v.*

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268 See id. at 209-11.
269 See id. at 222.
270 See Kathryn R. L. Rand and Steven Andrew Light, *Indian Gaming Law and Policy* 29-33 (2006) (providing a brief overview of the political responses to Indian gaming after the decision in *Cabazon*).
272 See id.
273 See id. at § 2704-09.
274 See Taylor, supra note ___, at 885-87[Michigan State] (describing the lack of political representation that tribes have in Congress).
Arizona State Tax Commission\textsuperscript{276} when Justice Thurgood Marshall explained that state infringement of tribal sovereignty should be a contextual backdrop within which the preemption analysis takes place.\textsuperscript{277} After McClanahan it was not entirely clear whether state infringement of tribal sovereignty could be an independent basis for blocking a state action that affected a tribe, its members, or an activity taking place within a tribe’s reservation boundaries.\textsuperscript{278}

State infringement of tribal sovereignty, at least as a theoretical matter, does remain a separate and independent bar to the exercise of state authority within Indian country.\textsuperscript{279} The United States Supreme Court made this quite clear in Oklahoma Tax Commission v. Chickasaw Nation.\textsuperscript{280} In that case, the Chickasaw Nation contended that language in one of its treaties, which operated as federal law under the supremacy clause of the federal Constitution, preempted Oklahoma’s state income tax on tribal members who worked for the tribe but who lived off the reservation in Oklahoma.\textsuperscript{281} Justice Ginsburg interpreted the text of the particular treaty as having no preemptive effect\textsuperscript{282} and, therefore, was unwilling to bar the imposition of the state income tax in the absence of federal legislation that could be read as providing some form of implied preemption under the Indian preemption doctrine.\textsuperscript{283} Of critical importance for purposes of the present discussion, Justice Ginsburg noted that the state income tax could be barred by application of the infringement test.\textsuperscript{284} Her opinion, however, indicated that the issue was not raised below or in the case before the Supreme Court.\textsuperscript{285} As a result, consideration of infringement in the Chickasaw Nation case would have been improper.\textsuperscript{286}

So when does infringement come into play? When does the exercise of state authority so infringe a tribe’s right to self-government that the state action is rendered invalid? From the decided cases, I conclude that impermissible infringement almost never provides a basis for invalidating the exercise of state authority affecting a tribe. The infringement test is often not asserted because the Indian preemption doctrine provides a sufficient basis for evaluating the propriety of a state exercising its authority. In part, this explains why few cases actually ask and answer the infringement question.

In this article, I assert that the infringement test has been operating as an unarticulated prong of judicial analysis in dealing with direct state taxation of tribes and their members when engaged in on-reservation activity. It is important to recall that federal case law uniformly holds that direct state taxation of a tribe or its members for

\textsuperscript{276} 411 U.S. 164 (1973).
\textsuperscript{277} See id. at 172.
\textsuperscript{278} See Bracker, 448 U.S. at 142 (indicating that infringement is a test separate from preemption).
\textsuperscript{279} See id.
\textsuperscript{280} See 515 U.S. 450 (1995).
\textsuperscript{281} See id. at 465.
\textsuperscript{282} See id. at 466 (“We do not read the Treaty as conferring super-sovereign authority to interfere with another jurisdiction's sovereign right to tax income, from all sources, of those who choose to live within that jurisdiction's limits.”).
\textsuperscript{283} See id. at 465 (quoting Mescalero Apache Tribe v. Jones, 411 U.S. 145, 148-49 (1973), which stated that Indians going beyond their own boundaries subject themselves to state taxation in the absence of federal law preempting that taxation).
\textsuperscript{284} See id. at 464 (1995).
\textsuperscript{285} See id.
\textsuperscript{286} See id. at fn. 14.
activity within Indian country is categorically barred. The only additional refinement of this principle is legal incidence. So, if we assume that the legal incidence of a tax falls on a tribe or one of its members for activity on the reservation, then the state tax is invalid. The Supreme Court, even though it has recognized this principle in numerous cases, has never provided a rationale for this categorical tribal immunity from state taxation. Obviously, the Court’s unstated rationale must be infringement. The Court is recognizing that state taxation of a tribe or its members for activity undertaken within Indian country would infringe the tribe’s sovereignty and prevent it from or impede it in enacting and enforcing its own laws.

We can locate infringement analysis as a subtext of tribal immunity from state taxation in a line of cases starting with the Kansas Indians and ending with Wagnon. In the Kansas Indians case, the Court stated that as “long as the United States recognizes [the tribe’s] national character…their property is withdrawn from” the state’s power to tax. The Court’s focus on the tribe’s national character undoubtedly recognizes the principle that tribes are self-governing political communities. The Court uses similar language in The New York Indians case showing the recognition of political separation. The concern about a tribe’s sovereignty becomes explicit in McClanahan:

The Indian sovereignty doctrine is relevant, then, not because it provides a definitive resolution of the issues in this suit, but because it provides a backdrop against which the applicable treaties and federal statutes must be read. It must always be remembered that the various Indian tribes were once independent and sovereign nations, and that their claim to sovereignty long predates that of our own Government.

This quote from McClanahan shows that the starting and ending point is the tribe’s aboriginal sovereignty: its right to exist as a political community governed, as much as possible, by laws of its own making. The Wagnon Court, even though it refused to apply

287 See Oklahoma Tax Comm’n v. Chickasaw Nation, 515 U.S. 450, 458 (1995) (concluding that a state cannot tax tribes or their members for on-reservation activity unless authorized by Congress); County of Yakima v. Confederated Tribes & Bands of Yakima Nation, 502 U.S. 251, 258 (1992) (finding that states have no power to tax reservations lands); Bryan v. Itasca County, 426 U.S. 373 (1976) (holding that Itasca County in Minnesota could not impose its property tax on a tribal member’s mobile home located on the reservation); Moe v. Confederated Salish & Kootenai Tribes of Flathead Reservation, 425 U.S. 463, 475-481 (1976) (prohibiting the imposition of Montana’s cigarette excise tax on sales by on-reservation smoke shops to tribal members); McClanahan v. Ariz. State Tax Comm’n, 411 U.S. 164, 165-66 (1973) (ruling that Arizona could not impose its income tax on the wages earned by a member of the Navajo Nation who lived and worked on the reservation); The New York Indians, 72 U.S. (5 Wall.) 761, 764 (1866) (finding tribal lands immune from New York property taxes until the rights of possession of the tribe have been extinguished through a lawful treaty); The Kansas Indians, 72 U.S. (5 Wall.) 737, 757 (1866) (holding that a Kansas county could not impose its property tax on property owned by a Shawnee tribal member owning the property under an allotment provided by treaty).


289 The Kansas Indians, 72 U.S. (5 Wall.) at 757.

290 See The New York Indians, 72 U.S. (5 Wall.) at 764 (recognizing the tribe’s “original rights” and entitlement to “undisturbed enjoyment” of their lands).

291 McClanahan, 411 U.S. at 172-73.
the Bracker balancing test, nonetheless conceded that in different circumstances the tribal interest would have to be considered even if the legal incidence of the tax did not fall on the tribe or a tribal member.

Unfortunately, state income taxation of interest paid to bond owners of tribal bonds is not a tax whose legal incidence falls on the tribe. Therefore, the line of cases just discussed does not provide clear precedent supporting a bar against state income taxation. Such a categorical bar would arise if the owner of a tribal bond was another tribe. In such a case, the legal incidence of the state income tax falls on the tribe and most courts probably would conclude that most of the transaction takes place within Indian country. For purposes of this article, I am assuming that the tribal bond owner is a non-Indian living in a state with an income tax that applies to interest income on bonds.

But if we unpack the infringement subtext from the tribal tax immunity cases, then we see that the United States Supreme Court does have some concern about the exercise of state power affecting the operation of tribal government. The Court seems to be assuming that Chief Justice John Marshall was correct that the power to tax is the power to destroy. Accordingly, tribes deserve protection from the state’s taxing power, and the United States Supreme Court, in the absence of any treaty language or federal statute, has been willing to provide this protection. If states could tax tribes, then they could destroy them. For example, state property taxation would likely bankrupt many tribes with sizable reservations and would impose, in many cases, an impossible financial burden on many of their members.

Noting this judicial concern for protecting tribal governments in the making and administration of their laws, we can now look at the process of tribal borrowing and its connection with the operation of their governments. Perhaps looking first at federal and state borrowing will place the matter in a proper perspective. The federal and state governments could not operate without the power to borrow money.

In early 2009, the national debt of the United States stood at more than $10.7 trillion. This represents about 75% of the country’s gross domestic product for 2008 and about 428% of total tax revenues for the fiscal year 2008. If and when Congress fails to increase the

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292 The Bracker balancing test derives from the case of White Mountain Apache Tribe v. Bracker, 448 U.S. 136 (1980). In Bracker the Court entered into a “particularized inquiry into the nature of the state, federal, and tribal interests at stake” to determine whether a state tax imposed on a non-Indian for activity within the White Mountain Apache reservation was subject to state taxation. See id. at 145.

293 See Wagnon, 546 U.S. at 102.


295 It is no coincidence that the grant in the Constitution of the power to tax is followed by the power to “borrow money on the credit of the United States.” U.S. CONST. art. I, cl. 2.


ceiling on the national debt, then federal government shutdowns become a real possibility. The total debt of the states was estimated to be $2.2 trillion as of 2005-06. The total debt of the states was estimated to be $2.2 trillion as of 2005-06.\footnote{See Bureau of the Census, U.S. Department of Commerce, State & Local Government Finances by Level of Government and by State: 2005-06, \url{http://www.census.gov/govs/estimate/0600ussl_1.html}.
}

Many state and local governments view their power to borrow money to be an indispensable tool in accomplishing core governmental functions.\footnote{See, e.g., Brief for the National Association of State Treasurers as Amicus Curiae Supporting Petitioners, Dep’t of Revenue of Kentucky v. Davis, 553 U.S. ___ (2008), 2006 U.S. Briefs 666. In this brief, the National Association of State Treasurers asserted:

The authority of States to borrow money, like the authority to raise revenues through taxation, is a core aspect of State sovereignty. State and local governments must have access to capital markets in order to carry out their essential function of protecting and promoting the health, safety, and welfare of their citizens. By issuing municipal bonds, States and their political subdivisions are able to raise funds for costly projects that benefit State citizens over extended periods of time without having to depend entirely on tax revenues. In the absence of municipal bonds, many important State and local government initiatives would have to be delayed or cancelled.}

Governments as borrowers must pay interest on the money they borrow. The interest that the lender earns as the owner of a federal or state bond is income.\footnote{See I.R.C. § 61(a)(4) (2008).} But the federal and state governments quickly learned that lenders would accept lower rates of interest if the bond interest was exempt from income tax. The practice of the federal government is quite interesting. Congress has long provided that interest earned by lenders to the federal government is exempt from state income tax.\footnote{See 31 U.S.C. § 3124 (2008) (providing that interest on federal obligations is exempt from state taxation). This provision originates from the time of the Civil War. See Act of Feb. 25, 1862, 12 Stat. 345, 346, ch. 33, § 2 (prohibiting state taxation of “federal stocks, bonds, and other securities”).} Congress has not provided an exemption for federal income tax purposes primarily because higher interest income paid just comes back to the federal government through higher income tax revenues.\footnote{In the case of U.S. Savings Bonds, the interest income is deferred, not exempt. See I.R.C. 454 (a) (2008).}

State governments have insisted on exemption from the federal income tax from the very beginning.\footnote{See, e.g., Revenue Act of 1916, 39 Stat. 756, 758 , ch. 463, § 4.} The potential federal income taxation of municipal bond interest became a sticking point in the ratification of the Sixteenth Amendment to the United States Constitution. Congress has never seriously considered repealing this exemption, although it has allowed limited federal income taxation of private activity bonds.\footnote{See Arthur A. Ekrich, Jr., The Sixteenth Amendment: The Historical Background, 1 CATO JOURNAL 161, 175-76 (1981) (describing 1) the opposition of Charles Evans Hughes, then Governor of New York, to the ratification of the Sixteenth Amendment, on the grounds that the federal income tax would impair the borrowing capacity of states and local government and 2) New York’s initial rejection of the amendment) and STEVEN R. WEISMAN, THE GREAT TAX WARS: LINCOLN TO WILSON—THE FIERCE BATTLES OVER MONEY AND POWER THAT TRANSFORMED THE NATION 256-59 (2002) (describing how the opposition of Charles Evans Hughes in 1910 made ultimate ratification of the Sixteenth Amendment doubtful).}

and total 2008 federal revenues of $2.5 trillion, the national debt is 428% of total federal revenues (10.7 divided by 2.5 = 428%).

\footnote{Id. See I.R.C. § 61(a)(4) (2008).}

\footnote{See 31 U.S.C. § 3124 (2008) (providing that interest on federal obligations is exempt from state taxation). This provision originates from the time of the Civil War. See Act of Feb. 25, 1862, 12 Stat. 345, 346, ch. 33, § 2 (prohibiting state taxation of “federal stocks, bonds, and other securities”).}

\footnote{In the case of U.S. Savings Bonds, the interest income is deferred, not exempt. See I.R.C. 454 (a) (2008).}

\footnote{See, e.g., Revenue Act of 1916, 39 Stat. 756, 758 , ch. 463, § 4.}

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\footnote{For the definition of private activity bonds, see I.R.C. § 141(a) (2008).}
through the federal alternative minimum tax.\textsuperscript{307} State governments, in order to encourage investment in their bonds, have long denied state income tax exemption for out-of-state municipal bonds.\textsuperscript{308} And, as already noted, this practice in Kentucky led two Kentucky taxpayers to challenge the practice on grounds that discriminatory state income taxation violated the dormant commerce clause.\textsuperscript{309} In the \textit{Davis} case, the Supreme Court, relying on the importance borrowing plays for the operation of government, allowed Kentucky’s discriminatory practice of taxing out-of-state bonds and exempting in-state bonds.\textsuperscript{310} Interestingly, the Court did not focus on the importance of Kentucky’s taxing power as applied to interest on out-of-state bonds precisely because the intent of the Kentucky tax law was to encourage Kentucky residents to purchase in-state bonds.\textsuperscript{311} In addition, sister states supported Kentucky’s position.\textsuperscript{312} And finally, although not noted by the Court, Congress has not enacted any federal legislation dealing with this wide-spread tax discrimination practiced by 41 states.\textsuperscript{313}

Given the importance of borrowing to most governments, including tribal governments, it is safe to conclude that tribal borrowing of money is a core governmental function. State taxation of interest on tribal bonds increases the cost of tribal borrowing.\textsuperscript{314} Every dollar of state income tax collected on tribal bond interest increases the cost of borrowing for the tribe by about $1.\textsuperscript{315} The fiscal effect of this cost flows directly to governmental operation because the government issuing the bond must pay this higher interest rate. The federal law providing the federal exemption requires that the proceeds of tribal bonds be used only for the performance of an “essential governmental function.”\textsuperscript{316} As a matter of federal law, the tribal bond transaction, by definition, connects to the performance of core governmental functions.

Given the federal and state context in which governmental borrowing is a core function and the federal law restricting spending of tribal bond proceeds on essential governmental functions, it becomes clear that state income taxation of tribal bond interest infringes a tribe’s right to self-government. In this sense, then, direct state taxation of a tribe, which the Supreme Court has found to be categorically improper, is really no different, as a matter of substance, from direct state taxation of tribal borrowing. Outside the tribal context, state and federal taxation of governmental borrowing reveals the political reality that income taxation of bond interest directly affects the cost of borrowing. Accordingly, Congress provides a federal income tax exemption for interest on municipal bonds\textsuperscript{317} and imposes a federal prohibition against state income taxation of interest on federal borrowing.\textsuperscript{318} The federal/state dynamic has reached a point of political accommodation precisely because the structure of Congress as a democratic

\textsuperscript{308} See Dept. of Rev. of Ky. V. Davis, 553 U.S. ____ (2008).
\textsuperscript{309} See id. at ____.
\textsuperscript{310} See id. at ____.
\textsuperscript{311} See id. at ____.
\textsuperscript{312} See id. at ____.
\textsuperscript{313} See id. at ____.
\textsuperscript{314} See id. at ____.
\textsuperscript{315} See id. at ____.
\textsuperscript{316} See I.R.C. § 7871(c)(1).
\textsuperscript{317} See I.R.C. § 103(a) (2008).
institution includes representation of the political interests of states.\textsuperscript{319} As I already discussed in the preceding section, if federal law provides no ready or obvious answer to a question involving the limits of state authority within Indian country, then it is appropriate for a federal court to adopt a judicial approach that decides the case in favor of the tribal interest.\textsuperscript{320} If the decision is a mistake or stimulates a federal legislative response, then the states are in a position to look after their own interests in Congress. Tribes, on the other hand, have no institutional place at the political table. Fortunately, the process of most federal legislation includes congressional hearings at which tribal representatives can express their views. Of course, they often lack the political power to carry them out. But when their views have the weight of fairness and reason behind them, the final federal legislation may incorporate these views.\textsuperscript{321}

In summary, then, judicial protection of tribal sovereignty and self-government through a robust infringement doctrine accommodates the often conflicting tribal, state, and federal interests. Tribes should receive the highest level of judicial protection because the historical forces of dispossession have left them with no institutional voice within our constitutional framework. States, in contrast, have political representation in Congress through the Senate. In addition, most members of the House of Representatives come from backgrounds in which they served as elected or appointed positions at the state or local level. Quite starkly, no former governmental official from a federally recognized Indian tribe serves in Congress. Finally, Congress has plenary power over Indian affairs and is, therefore, well situated to adjust, modify, reverse, or confirm judicial actions that use the infringement doctrine to protect tribes from the exercise of state and local governmental powers.

In the case of tribal bonds, state taxation of the interest income extracts close to a dollar for dollar cost to the tribes. The United States Supreme Court in \textit{Davis} has confirmed that the borrowing function of a state or local government is so crucial and important that discriminatory state taxation of out-of-state bonds does not violate the dormant commerce clause. So why should we permit state income taxation of out-of-state bonds but not permit state income taxation of tribal bonds? Posing the question this way in the context of the infringement doctrine suggests that my application of the doctrine is inconsistent and illogical. My position is logical, however, if we recognize two things. First, states, as I have already explained, have an institutional place in Congress where unwanted discrimination can be remedied through explicit federal legislation passed under the interstate commerce clause. Second, states, at least most of them, have economies that are large enough to provide investors for their own bonds. In contrast, most tribes would not have an investor base sufficient to provide buyers for their bonds. In addition, most states have an income tax, but no tribes, at least as far as I know, have an income tax. Consequently, tribal members living on the reservation would receive no tribal income tax incentive from buying a tribal bond. Admittedly, the federal incentive would still apply. Nonetheless, the average tribe finds itself in a wholly different set of fiscal and economic circumstances than does the average state. Therefore,

\begin{itemize}
\item \textsuperscript{319} See Taylor, \textit{supra} note ___ at 885-90 [Michigan State] (discussing how the constitutional and political structures further the representation of states’ interests in Congress but not those of tribes.)
\item \textsuperscript{320} See discussion \textit{supra} accompanying notes ___ - ___.
\item \textsuperscript{321} See Taylor, \textit{supra} note ___, at 888-89 [Michigan State] (discussing this process in the context of Congress’ enactment of the Indian Gaming Regulatory Act).
\end{itemize}
it makes perfect sense that states should not be able to impose their income tax on interest from tribal bonds while at the same time taxing interest on bonds issued by sister states.

V. THE INDIAN COMMERCE CLAUSE

Under the Constitution, Congress is granted the power to "regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes." The Supreme Court has viewed this language as creating three separate grants of power to Congress. As a matter of textual analysis, the Court refers to the powers as located within 1) the interstate commerce clause, 2) the foreign commerce clause, and 3) the Indian commerce clause. If and when Congress exercises its power in one of these spheres, the federal legislation may explicitly or impliedly preempt state law. In the context of the Indian preemption doctrine discussed above, I observed that Congress has not explicitly preempted state income taxation of interest on tribal bonds. I asserted, however, that the Indian preemption doctrine provides a broad sweep in which a federal legislative presence justifies a balancing of the respective interests. After balancing those interests, I concluded that the Indian preemption doctrine should prohibit state income taxation of interest paid on tribal bonds.

In this part of the discussion, I investigate whether the Indian commerce clause is like the interstate commerce clause and whether the negative implications of the Indian commerce clause might prohibit state income taxation that discriminates against tribal bonds in favor of in-state bonds. I conclude that there is a dormant prong within the Indian commerce clause.

The dormant commerce clause is a judicial add-on to the interstate commerce clause contained in the United States Constitution. The text of the clause itself provides Congress with the power to regulate commerce "among the several States." Consequently, the dormant commerce clause comes into play only when Congress has not undertaken legislation that actually regulates interstate commerce. In such cases, the dormant commerce clause prohibits states from undertaking actions that unduly burden commerce.

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322 U.S. Const. art. I, § 8, cl. 3.
323 See New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 273–274 (1988) (emphasizing that the dormant part of the interstate commerce clause is focused on preventing states from engaging in economic protectionism).
324 See United States v. Clark, 435 F.3d 1100, 1113 (9th Cir. 2006) (noting that the Supreme Court "has read the Foreign Commerce Clause as granting Congress sweeping powers").
326 See discussion supra at note _____.
327 See discussion supra at note ____.
328 See New Energy Co. of Ind. v. Limbach, 486 U.S. 269, 273–274 (1988) (emphasizing that the dormant part of the interstate commerce clause is focused on preventing states from engaging in economic protectionism).
329 See Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970) (stating that in the absence of discrimination, a state law will be upheld, against the dormant commerce clause, "unless the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.").
or discriminate against interstate commerce.\textsuperscript{330} In general, the goal of the dormant commerce clause is to prohibit states from undertaking measures that constitute economic protectionism.\textsuperscript{331} In the context of taxation, the dormant commerce clause generally prohibits states from taxing in a way that creates an undue burden on, or that discriminates against, interstate commerce.\textsuperscript{332}

Within the Indian commerce clause, the Supreme Court ultimately rejected the undue burden analysis in cases involving simultaneous tribal and state taxation but recognized a problem when state taxation discriminated against a tribe or a tribal interest. In \textit{Washington v. Confederated Tribes of the Colville Indian Reservation}, the Court rejected the undue burden approach where the sale of cigarettes within a tribe’s reservation was subject to both a state tax and a tribal tax.\textsuperscript{333} The Court, however, recognized that states could not impose their taxes in a way that discriminated against tribes.\textsuperscript{334} In a concurring/dissenting opinion, Justice Rehnquist noted that the Indian commerce clause, by implication, prohibits “discriminatory state action”.\textsuperscript{335}

In \textit{Merrion v. Jicarilla Apache Tribe}, an oil and gas lessee contested the validity of a tribal severance tax imposed on the lessee’s mineral extraction activities.\textsuperscript{336} The lessee asserted, among other things, that the tribal tax, when combined with the state tax, was invalid as an undue burden on interstate commerce.\textsuperscript{337} The Court briefly discussed the difference between the interstate commerce clause and the Indian commerce clause.\textsuperscript{338} The Court observed that the Indian commerce clause has a dormant side that serves “as a shield to protect Indian tribes from state and local interference”.\textsuperscript{339} Because the question here involved the power of the tribe to tax, the Court found that the dormant Indian commerce clause was inapplicable.\textsuperscript{340} Instead, the Court applied its interstate commerce clause jurisprudence and found that Congress had acted affirmatively in this case by providing a statutory and regulatory regime that included federal approval of the tribal tax.\textsuperscript{341} The Court went on to consider whether the tribal tax, assuming no federal action, would have survived dormant interstate commerce clause scrutiny. The Court concluded that the tribal tax satisfied the dormant commerce clause test\textsuperscript{342} laid out in \textit{Complete Auto Transit, Inc. v. Brady}.\textsuperscript{343} Specifically, the Court found that the tribal tax did not discriminate against interstate commerce.\textsuperscript{344}

\begin{itemize}
\item \textsuperscript{330} See \textit{Philadelphia v. New Jersey}, 437 U.S. U.S. 617, 624 (1978) (stating that a discriminatory state law affecting interstate commerce is usually invalid).
\item \textsuperscript{331} See \textit{New Energy Co. of Ind. V. Limbach}, 486 U.S. 269, 273-74 (1988).
\item \textsuperscript{333} See 447 U.S. 134, 157 (1980).
\item \textsuperscript{334} See id.
\item \textsuperscript{335} See id. at 177.
\item \textsuperscript{336} See 455 U.S. 130, 136 (1982).
\item \textsuperscript{337} See id.
\item \textsuperscript{338} See id. at 153-54.
\item \textsuperscript{339} See id.
\item \textsuperscript{340} See id. at 154.
\item \textsuperscript{341} See id. at 155.
\item \textsuperscript{342} See id.
\item \textsuperscript{343} See 430 U.S. 274, 279 (1977) (allowing a state tax on interstate commerce if there is nexus, fair apportionment, and no discrimination).
\item \textsuperscript{344} See 455 U.S. at 157-58. The Court addressed the issue of whether multiple taxation was an undue burden in footnote 26 of its opinion and suggested that a state tax might violate the interstate commerce
In *Cotton Petroleum Corporation v. New Mexico*, the United States Supreme Court again considered whether multiple taxation by a state and a tribe on the same transaction constituted an undue burden on interstate commerce in violation of the Indian commerce clause. Cotton Petroleum involved mineral extraction from lands on the Jicarilla Indian Reservation and served to test the validity of state taxation in the same factual context as the *Merrion* case. In Cotton Petroleum, the Court relied on the *Colville* case and rejected this multiple-burden argument because the New Mexico severance tax was non-discriminatory. The New Mexico tax applied to all oil and gas produced within the state whether from Indian or non-Indian lands and whether consumed in-state or exported out of state. The Court, however, indicated that a discriminatory tax would be another matter. The Court suggested that a discriminatory state tax, one that applied to tribal wells and not to wells located off the reservation, would be invalid as a violation of the Indian commerce clause. This analysis in Cotton Petroleum suggests that the Indian commerce clause does have a limited negative implication in cases when state taxation discriminates against the tribe or its interests.

Simple fairness requires that the Indian commerce clause should provide this protection against discriminatory state taxation. If we look at these two cases in which state taxation was permitted within Indian Country, it is obvious that discriminatory state taxation would have been unfair and would have violated Indian commerce clause principles. In Colville and Cotton Petroleum, for example, the Court would have found the state taxes invalid as a violation of the Indian commerce clause if those taxes had applied only on the reservation or at a higher rate for on-reservation transactions. This shows that there is actually a dormant Indian commerce clause because the rationale in both cases was based on the conclusion that Congress had passed no laws otherwise implicating application of the Indian preemption doctrine. Instead, the Court in both cases was saying that discriminatory state taxation would violate the Indian commerce clause. In addition, the Court in Merrion, as a matter of fundamental principle in federal Indian law, stated that the Indian commerce clause operates to protect tribes from the exercise of state power.

In the context of tribal bonds, state income tax rules that allow an exemption only for in-state bonds discriminate against tribal bonds issued within the state or by tribes located out-of-state. This is a case of simple discrimination in which a state taxes interest on all tribal bonds but provides an exemption for interest on its own bonds. The presence of discrimination is factually obvious and therefore violates the dormant Indian commerce clause.

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345 See 490 U.S. 163 (1989).
346 See id. at 167.
347 See id. at 188 (citing Colville as implicitly allowing simultaneous tribal and state taxation on the same activity).
348 See id. at 189.
349 See id.
350 See id.
351 See 455 U.S. at 153-54 (1982).
352 For the leading article asserting that there is a dormant Indian commerce clause, see Robert N. Clinton, The Dormant Indian Commerce Clause, 27 CONN. L. REV. 1055 (1995) (challenging the correctness of
The *Davis* case, however, permits discriminatory state taxation against out-of-state bonds by placing the in-state tax preference within the governmental function exception.\textsuperscript{353} Under this exception, discrimination against interstate commerce is permitted when the activity involves the exercise of a core governmental function.\textsuperscript{354} The Court sees governmental borrowing and the use of borrowed funds as a core governmental function.\textsuperscript{355} The Court then sees the in-state tax preference as a permissible method of facilitating this borrowing function.\textsuperscript{356} In support of its reasoning, the Court points to the long and pervasive history of virtually all states engaging in discriminatory taxation and the failure of a single state to oppose the discriminatory practice through the filing of an amicus curie brief in the case.\textsuperscript{357} Finally, the Court also notes that Congress seemed aware of the practice but was unwilling to step in to provide a legislative remedy.\textsuperscript{358}

In the context of tribal bonds, does the *Davis* case provide a ready answer to state income taxes that discriminate against interest on tribal bonds? Obviously the dormant interstate commerce clause is no longer a problem because the Court has placed the in-state tax preference within the governmental function exception. The dormant Indian commerce clause, however, does remain a problem precisely because *Colville* and *Cotton Petroleum* acknowledge that it probably prohibits discriminatory state taxation. Both *Colville* and *Cotton Petroleum* were cases where the validity of the state tax involved reservations located wholly within the state imposing its tax. In the case of tribal bonds, the state income tax will apply to in-state tribal bonds and to out-of-state tribal bonds. For example, if a tribe within New York issues bonds and one tribal bond owner is a resident of New York and another of Minnesota, then the two situations present substantially different cases.

First, let us consider the New Yorker. The New Yorker who owns a tribal bond from a tribe located within New York would be subject to the New York income tax. This tax would discriminate against the tribal bond solely because the issuer is a tribe. If a city or county within New York located right next to the tribe issued its own bond, then the in-state bond would be exempt from the New York income tax. Except for the presence of a discriminatory state tax, these hypothetical facts are very close to the facts in *Colville* and *Cotton Petroleum*, cases in which the Court seemed rather firm in its commitment to protect the tribes from discriminatory state taxation.

On New York’s side, the state could still argue, as Kentucky did in *Davis*, that state and local borrowing is a core governmental function that can be promoted through the granting of a tax exemption for in-state bonds. New York would need to argue that the tribe, although physically located within the state, is politically separate from the state and has sufficient and independent sovereignty to borrow its own funds, just like a sister state. In fact, New York could contend that the federal law granting federal income tax exemption for interest on tribal bonds reclassifies the tribe as a state in order to create the

\textsuperscript{353} See 553 U.S. at ___.
\textsuperscript{354} See id. at ___.
\textsuperscript{355} See id. at ___.
\textsuperscript{356} See id. at ___.
\textsuperscript{357} See id. at ___.
\textsuperscript{358} See id. at __.
exemption. On its side, the tribe’s best argument would be that the dormant Indian
commerce clause is designed to protect tribes from the exercise of state powers that harm
the tribe’s sovereignty. New York income taxation of the interest on the tribal bond
directly increases the tribe’s borrowing costs and adversely affects the exercise of a core
governmental function: borrowing money. In addition, the tribe could argue that it, like
almost all other tribes, lacks the economic base of individual states sufficient to sell
bonds to resident tribal members. Finally, the tribe could assert that its bond issue, along
with other tribal bond issues, is such a small part of the tax-exempt bond market that it
would not adversely affect New York’s cost of borrowing.

Switching now to the Minnesotan who buys a tribal bond from a New York tribe,
we see that Colville and Cotton Petroleum lose their factual similarity. Here Minnesota
could argue that it is treating all out-of-state governmental bonds the same by subjecting
their interest income to the state income tax. Under this line of argument, the Supreme
Court might very well find that the dormant Indian commerce clause does not apply
because there is no discrimination, except in the case of tribes located within Minnesota.
Nonetheless, the tribe in New York could still show discrimination, but the Court would
likely draw a parallel to the Davis case.

The Davis case, however, should not extend to out-of-state tribal bonds precisely
because tribes are not states. Tribes, unlike states, lack representation in Congress.
Tribes do not impose income taxes and, therefore, are not in a position to favor their own
bonds through an income tax exemption. No single tribe has an economy as big as the
state with the smallest economy. Because tribes have not had a history of bond issuing,
they have not been in a position to participate in a nation-wide system granting an in-state
tax exemption for in-state bonds. Finally, most tribes lack the political representation
within states to secure equality of treatment as in-state bond issuers.

A conclusive resolution of the issue must await a Supreme Court decision,
remedial federal legislation, or a pro-tribe approach adopted by individual states.

VI. RACIAL DISCRIMINATION

The equal protection clause of the Fourteenth Amendment circumscribes a state’s
power to engage in racial discrimination. So, for example, if a state varied its tax rate
based on race, then such a tax would be unconstitutional unless the state could provide a
compelling state interest to justify such taxation. In the context of tribal bonds, states
whose income taxation of bond interest discriminates based on the in-state/out-of-state
distinction should be able to survive constitutional scrutiny under the equal protection
clause of the Fourteenth Amendment because the discrimination is not racial but
geographical. For example, imposing the Wisconsin income tax on all bonds issued by
governmental entities located outside the boundaries of the state does not discriminate

359 Cotton Petroleum emphatically makes this point. See 490 U.S. at 192-93.
360 See U.S. CONST. amend. XIV, § 1 providing that no state shall “deny to any person within its
jurisdiction the equal protection of the laws.”
361 See Grutter v. Bollinger, 539 U.S. 306, 324-25 (2003) (subjecting race-conscious admissions to a state-
supported law school to the compelling-state-interest analysis, which, presumably, would apply in the
context of state taxation).
362 See WIS. STAT. § 71.05(1)(c) (2008) (extending exemption from the Wisconsin income tax only for
enumerated bonds, all of which must be issued within the state).
against tribal bonds as a separate category. Instead, the discrimination is based on the bond issuer’s location outside of Wisconsin, whether the issuer is the City of New York or the Navajo Nation.

The problem of racial discrimination, however, does arise for a state with an income tax that applies to tribal bonds issued by tribes located within that state’s boundaries. In California, for example, exemption from state income taxation extends only to bonds issued by the state or by local governments.\(^{363}\) California has more than 100 federally recognized Indian tribes located within its boundaries.\(^{364}\) Any bonds issued by these tribes would be subject to the California income tax because that state defines income as all income and specifically excludes only interest on bonds issued by the state and by local governments.\(^{365}\)

Precisely stated, is the state income taxation based on the racial characteristic of the tribe issuing the bond? Arguably, this is the case. A federally recognized Indian tribe is a distinct political entity comprised of members.\(^{366}\) Membership in a tribe is a question of tribal self-determination.\(^{367}\) In general, tribes adopt membership rules as part of their law-making process.\(^{368}\) These membership rules usually require some genetic connection in the form of blood quantum or ancestry.\(^{369}\) As a result, one could argue that many or most federally recognized Indian tribes are political entities that use race as a qualifying characteristic for membership.\(^{370}\) Stated another way, a tribe’s membership is very often comprised of Native Americans based on some form of ancestral connection.

Therefore, if a state exempts the interest income of a bond issued by one of its cities but refuses a comparable exemption for interest income earned on a tribal bond issued by a tribe located geographically within the state, then reason for the discrimination is arguably racial. If so, then the state would need a compelling reason to engage in such racial discrimination.

The leading case on racial discrimination involving Native Americans is Morton v. Mancari.\(^{371}\) In Mancari, the United States Supreme Court decided that a federal hiring preference for Native Americans was not unlawful racial discrimination because the

\(^{363}\) See CAL. REV. & TAX CODE § 17133 (2008) (extending exemption only to bonds issued by state and local governments of California).

\(^{364}\) See Indian Entities Recognized and Eligible To Receive Services From the United States Bureau of Indian Affairs, 73 Fed. Reg. 18553-57 (April 4, 2008).

\(^{365}\) See Analysis of SB 995: Exemption/Interest On Bonds Issued By Federally Recognized Indian Tribal Government Located In This State (California Legislature 2005), http://www.ftb.ca.gov/law/legis/05_06bills/sb995_022205.pdf (explaining how the interest from tribal bonds issued by in-state tribes are subject to the California income tax). California never enacted this proposed legislation.

\(^{366}\) See Worcester v. Georgia, 31 U.S. (6 Pet.) 515, 559 (1832) (observing that “Indian nations had always been considered as distinct, independent political communities, retaining their original natural rights”).

\(^{367}\) See Santa Clara Pueblo v. Martinez, 436 U.S. 49, 55 (1978) (citing Roff v. Burney, 168 U.S. 218 (1897), which confirmed that membership decisions were within the exclusive power of the tribe).


\(^{369}\) See id.

\(^{370}\) See Rose Cuison Villazor, Blood Quantum Land Laws and the Race Versus Political Identity Dilemma, 96 CAL. L. REV. 801, 805-6 (identifying potential equal protection problems associated with political classifications based on blood quantum).

classification of a person as a Native American was political, not racial.\textsuperscript{372} If we apply the \textit{Mancari} rationale to state income taxation in the tribal bond setting, then we must conclude that the factor justifying the discrimination is a political one and not a racial one. In \textit{Mancari}, the Court concluded that the hiring preference practice was justified by a rational purpose. Presumably, then, a state could find a rational purpose for taxing in-state tribal bonds. Such a state would have to argue that the political separation of the tribe from the state is just as clear as the political separation of one state from another. Accordingly, a state can promote its own bonds by not allowing an exemption for bonds issued by politically separate tribes.

The \textit{Mancari} line of analysis, which focuses on political status and not racial status, is somewhat artificial because federally recognized Indian tribes are both politically separate and, in many cases, racially distinct. Perhaps it is best to acknowledge the presence of both of these two characteristics. The next step, then, should be to determine whether the discriminatory state taxation operates primarily at a political level or a racial level. The \textit{Davis} case seems to answer the question by noting that those states that tax bond interest from bonds issued out-of-state are doing so to promote their own in-state bonds. The discrimination is wholly political and favors the local interest and, therefore, does not amount to racial discrimination.

\textbf{CONCLUSION}

The exercise of a state power in a way that adversely impacts the sovereignty of a federally recognized Indian tribe has been a matter of serious concern to the United States Supreme Court since 1832.\textsuperscript{373} The limit of a state’s power to tax is very often the subject of judicial concern.\textsuperscript{374} In this article, I have investigated the limitations that states may face when they impose their income taxes on interest that investors earn on bonds issued by federally recognized Indian tribes. I have concluded that such state taxation is barred by the Indian preemption doctrine. The federal legislation that granted exemption for such interest for federal income tax purposes has the strength and breadth to preempt state income taxation. State income taxation of interest on tribal bonds also infringes tribal sovereignty. This infringement operates as an independent and second bar to state taxation. A third barrier to state taxation is the Indian commerce clause. Case law supports the conclusion that states cannot exempt in-state activities while taxing on-reservation ones. The \textit{Davis} case now allows states to discriminate against one another in the taxation of bond income. But this form of discrimination does not and should not apply to federally recognized Indian tribes because they occupy a totally different political and economic place in the United States. Finally, I have concluded that state discrimination against tribal bonds does not violate the equal protection clause of the Fourteenth Amendment because tribes are primarily political, rather racial, communities. Accordingly, a state would have a rational purpose for discriminating against tribal bonds.

\textsuperscript{372} See id. at note 24. “The preference is not directed towards a “racial” group consisting of “Indians”; instead, it applies only to members of “federally recognized” tribes. This operates to exclude many individuals who are racially to be classified as “Indians.” In this sense, the preference is political rather than racial in nature.”


\textsuperscript{374} See, \textit{e.g.}, \textit{Wagnon v. Prairie Band Potawatomi Nation}, 546 U.S. 95 (2005).
in favor of its own bonds. Nonetheless, the Indian preemption doctrine, state infringement of tribal sovereignty, and the dormant Indian commerce clause stand as independent barriers to a state’s power to impose its income tax on interest from tribal bonds.