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Winter 2020

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### Publication Information

Cowan, Mark J. (2020). "Taxing Cannabis on the Reservation". *American Business Law Journal*, 57(4), 867-911. <https://doi.org/10.1111/ablj.12174>

This is the peer reviewed version of the following article:

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# Taxing Cannabis on the Reservation

Mark J. Cowan\*

*American Indian tribes that enter the cannabis industry confront a multi-sovereign tax system that lacks certainty and horizontal equity. The complex interaction of state legalization and taxation of cannabis, federal tax law, the status of tribes as both governments and business enterprises, and the legal and tax landscape in Indian country can give tribes tax advantages and disadvantages compared to off-reservation cannabis dispensaries. This article analyzes these tax issues, examines them in the context of prior challenges posed by Indian gaming, and suggests reforms that address the tax inequities that can result from cannabis sales on Indian reservations.*

## INTRODUCTION

Cannabis. Taxes. Indian tribes. The law surrounding each of these areas is complex, uncertain, and at times mysterious. This article addresses the confluence of all three. Federally-recognized American Indian<sup>1</sup> tribes, like states, are sub-federal, sovereign governments. Tribal concerns must be considered in debates over cannabis<sup>2</sup> law.

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<sup>1</sup> This article uses the terms “Indian,” “Native American,” and “tribal member” interchangeably. The term “Indian” can be problematic in some contexts, but it is the term used by legal scholars, tribal members, and the law itself. See Nell Jessup Newton, *Memory and Misrepresentation: Representing Crazy Horse*, 27 CONN. L. REV. 1003, 1003 n.1 (1995) (indicating that the term “Indian” is generally used by reservation residents to identify the national group to which they belong).

<sup>2</sup> This article will use the term “cannabis” and “marijuana” interchangeably to refer to the psychoactive drug that is illegal under federal law but has been legalized for medical or recreational use by certain states. The term marijuana, or variants thereof, are often used in the law. But individuals in the industry tend to use the term cannabis. Andrea Romi, et al., *From the Black-Market to the Gray-Market: Accounting's Role in the Budding Cannabis Industry* 7, n.9 (Working Paper, December 19, 2017), <https://ssrn.com/abstract=3090386> [hereinafter *Gray-Market*].

Cannabis can be consumed in various forms, like cigarettes, tablets, oils, or edibles. See JAMES T. O'REILLY, *LEGAL GUIDE TO THE BUSINESS OF MARIJUANA* § 6:3 (2019). For purposes of this article, the method of delivery is not relevant. Also, this article does not address non-psychoactive cannabis-related products, like cannabidiol (CBD) or hemp—which sometimes have different legal treatment. See *id.* at §§ 10:11-10:12.

Indian tribes that enter the cannabis industry, and private cannabis businesses that operate in Indian country,<sup>3</sup> confront a multi-sovereign tax system that lacks certainty and horizontal equity.<sup>4</sup> The complex interaction of state legalization and taxation of cannabis, federal tax law, the status of tribes as both governments and business enterprises, and the legal and tax landscape in Indian country can give tribal cannabis stores advantages and disadvantages compared to off-reservation cannabis dispensaries. This article analyzes the tax issues that arise in the cannabis industry in Indian country, puts them in the context of prior challenges posed by Indian gaming, and suggests reforms that address the tax inequities that can result from cannabis sales on Indian reservations. These perspectives have not been analyzed in the extant academic literature.<sup>5</sup>

If the legalized cannabis industry is to grow,<sup>6</sup> it must be subject to a fair tax system. The best strategy for governments involved—federal, state, and tribal—is to put aside their differences and individual quests for easy revenue in favor of a fair and clear approach to taxing the industry.

This article is organized as follows. Part I reviews the current legal status of cannabis in the United States. Part II explains how the cannabis industry is currently taxed. Part III explains the unique tax landscape in Indian country. Part IV mines the history of the well-established Indian gaming industry for guidance in resolving tax issues in the emerging Indian cannabis industry. Part V identifies the key tax policy issues at stake and provides suggestions for the federal, state, and tribal governments in addressing the tax issues raised in this article.

## I. THE CURRENT STATE OF CANNABIS LAWS

Since the enactment of the Controlled Substances Act of 1970 (CSA), cannabis has been listed as a “Schedule 1” controlled substance.<sup>7</sup> It is illegal “to manufacture, distribute, or dispense, or possess with intent to manufacture, distribute, or dispense, a controlled substance.”<sup>8</sup> Schedule I

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<sup>3</sup> This article uses terms such as “Indian country,” “Indian lands,” “Indian territory,” and “reservations” interchangeably to refer to the territory that is under the jurisdiction of a particular Indian tribe. This article also assumes that the boundaries of a tribe’s territory are clear. In reality, there could be a threshold issue as to whether a transaction is actually taking place within “Indian country.” See COHEN’S HANDBOOK OF FEDERAL INDIAN LAW § 3.04 (Nell Jessup Newton et al. eds., 2012) [hereinafter COHEN’S HANDBOOK].

<sup>4</sup> The tax policy concept of horizontal equity, which holds that taxpayers in the same position (normally measured by their income) should pay the same tax, is explored in more detail at *infra* Part V.A.1.

<sup>5</sup> Pieces of the puzzle, however, have been explored. For commentary on Indian tribes and cannabis in general, see *infra* note 29; on federal tax issues associated with the cannabis industry, see *infra* note 61; and for analysis of state tax issues related to cannabis, see *infra* note 92.

<sup>6</sup> This article takes no position on whether cannabis legalization is good public policy. Instead, this article focusses on taxing the cannabis industry in fair manner in jurisdictions where *the voters and their elected representatives have decided legalization is in their best interests*.

<sup>7</sup> 21 U.S.C. § 812(c) (2018). In the Agricultural Improvement Act of 2018, Pub. L. 115-334 (Dec. 20, 2018), Congress amended the definition of marijuana to exclude hemp. 21 U.S.C. § 802(16)(B)(i) (2018). “Hemp” is defined in 7 U.S.C. § 1639o(1) (2018).

<sup>8</sup> 21 U.S.C. § 841(a)(1) (2018). There are severe punishments, including imprisonment and fines, for violating the CSA. See, e.g., 21 U.S.C. § 841(b) (2018).

controlled substances are ones the federal government has determined have high potential for abuse and no accepted medical use.<sup>9</sup>

#### A. *State Liberalization of Cannabis Laws*

States began to deviate from the federal ban in 1996, when California became the first state to allow the medical use of cannabis.<sup>10</sup> In general, California decriminalized the possession and cultivation of cannabis by patients and caregivers when recommended by a physician.<sup>11</sup> Since 1996, thirty-two additional states have passed similar laws<sup>12</sup>—although there is a great diversity in what use is allowed.<sup>13</sup>

Starting with Colorado in 2012, states began to relax restrictions on the recreational use of cannabis by adults. As of this writing, recreational cannabis is legal in eleven states:<sup>14</sup> Alaska,<sup>15</sup> California,<sup>16</sup> Colorado,<sup>17</sup> Illinois,<sup>18</sup> Maine,<sup>19</sup> Massachusetts,<sup>20</sup> Michigan,<sup>21</sup> Nevada,<sup>22</sup> Oregon,<sup>23</sup> Vermont,<sup>24</sup> and Washington.<sup>25</sup> These states generally allow an individual over 21 years of age to possess, cultivate, or use limited amounts of cannabis. States vary in the amount of cannabis allowed, where cannabis can be consumed, where and how much can be grown, whether and how retail sales are allowed, and regulation of the cannabis supply chain.<sup>26</sup> States usually require “seed to sale” tracking to prevent illegally-grown cannabis from “leaking” into

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<sup>9</sup> 21 U.S.C. § 812(b)(1) (2018).

<sup>10</sup> *State Medical Marijuana Laws*, NAT’L CONF. OF ST. LEGIS., <https://www.ncsl.org/research/health/state-medical-marijuana-laws.aspx#3> (Mar. 10, 2020) [hereinafter NCSL].

<sup>11</sup> *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 177 (2018).

<sup>12</sup> NCSL, *supra* note 10. Several states have more narrow exemptions for the use of “low TCH, High cannabidiol (CBD)” products. *Id.*

<sup>13</sup> O’REILLY, *supra* note 2, at § 2:1.

<sup>14</sup> Heather Gillers, *Cities Look to Marijuana Taxes for Help*, WALL ST. J., Feb. 5, 2020, at A2. The District of Columbia and U.S. territories Guam and the Northern Mariana Islands have also legalized recreational marijuana. NCSL, *supra* note 10.

<sup>15</sup> ALASKA STAT. §§ 17.38.010 to 900 (2015).

<sup>16</sup> CAL. HEALTH & SAFETY CODE §§ 11362.1-11362.5 (2017); CAL. BUS. & PROF. CODE §§ 26000-26231.2 (2017).

<sup>17</sup> COLO. CONST. ART. XVIII, § 16 (2018).

<sup>18</sup> 410 ILL. COMP. STAT. 705/10-5 (2019).

<sup>19</sup> ME. STAT. tit. 28-B, §§ 101-1102; 1501-1504 (2018).

<sup>20</sup> MASS. GEN. LAWS ch. 94G, §§ 1-21 (2017).

<sup>21</sup> MICH. COMP. LAWS §§ 333.27951-27967 (2018).

<sup>22</sup> NEV. REV. STAT. §§ 453D.020 (2020).

<sup>23</sup> OR. REV. STAT. §§ 475B.005-968 (2017).

<sup>24</sup> VT. STAT. ANN. tit. 18 §§ 4230a-c (2018).

<sup>25</sup> WASH. REV. CODE §§ 15.125.010-.060 (2019).

<sup>26</sup> A detailed review of state-by-state cannabis laws is not necessary for purposes of this article. *See generally* O’REILLY, *supra* note 2, at App. A (providing a state-by-state summary of recreational and medical cannabis laws).

the legal supply chain.<sup>27</sup> To avoid attracting federal scrutiny, states will typically require that the entire “seed to sale” process occur entirely within the state.<sup>28</sup> That is, cannabis cannot be sold in the state if it was grown outside of the state.

### B. Tribal Liberalization of Cannabis Laws

Following the lead of the states, Indian tribes have also ventured into the cannabis sector.<sup>29</sup> Tribes are generally more cautious, however, as they may be concerned about putting critical federal financial support in jeopardy by violating federal law.<sup>30</sup> Tribal governments, unlike the state governments, are likely to own and operate the cannabis businesses themselves.<sup>31</sup> In 2015, two tribes in Washington opened the first tribally-owned retail cannabis stores in the United States.<sup>32</sup> The Squaxin Island Tribe opened Elevation,<sup>33</sup> followed a month later by the Suquamish Tribe’s Agate Dreams.<sup>34</sup> In 2016, the Puyallup Tribe (also in Washington) announced plans to grow cannabis for medical use at its Salish Cancer Center.<sup>35</sup> The Puyallup tribe also operates Medicine Creek Analytics, which tests retail cannabis for pesticides and other harmful substances.<sup>36</sup>

In 2017, the Las Vegas Paiute Tribe opened NuWu Cannabis Marketplace,<sup>37</sup> a large recreational cannabis store. Its building is nearly 16,000 square feet and it features 170 feet of display counters and a 24-hour drive-thru.<sup>38</sup> Also in 2017, the Ely Shoshone Tribe in Nevada

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<sup>27</sup> *Id.* at § 13.4.

<sup>28</sup> *Id.* at § 13.1.

<sup>29</sup> There has been little academic analysis of the legal issues raised by cannabis in Indian country. *But see, e.g.*, Kyle Montour, *Where There’s Smoke, There’s Fire: The State-Tribal Quandary of Tribal Marijuana*, 4 AM. INDIAN L.J. 222 (2016) (exploring the state-tribal legal conflicts that could arise over cannabis in Indian country); Melinda Smith, Note, *Native Americans and the Legalization of Marijuana: Can the Tribes Turn Another Addiction into Affluence?*, 39 AM. INDIAN L. REV. 507 (2014-2015) (discussing how Indian tribes should be incorporated into a legal system in which the federal government legalizes cannabis).

<sup>30</sup> James Ellis, *Legal Weed Could be a Godsend for American Indian Tribes*, NEWSWEEK (Apr. 23, 2018) <https://www.newsweek.com/legal-cannabis-could-be-godsend-american-indian-tribes-895240>.

<sup>31</sup> For a rare exception, *see* Benjamin Moses Leff, *Tax Benefits of Government-Owned Marijuana Stores*, 50 U.C. DAVIS L. REV. 659, 659 (2016) [hereinafter Leff, *Government-Owned*] (reporting on a cannabis store in North Bonneville, Washington, which is owned by an entity created by the city government).

<sup>32</sup> Richard Walker, *Many Tribes Say Billion-Dollar Cannabis Business is a Gateway to Economic Development*, INDIAN COUNTRY TODAY (Feb. 25, 2019), <https://indiancountrytoday.com/news/many-tribes-say-billion-dollar-cannabis-business-is-a-gateway-to-economic-development-2mDYeqg8v02VmO-7SzjyQg>.

<sup>33</sup> ELEVATION, <https://high-elevation.com/> (last visited Feb. 7, 2020).

<sup>34</sup> AGATE DREAMS, <https://www.agatedreams.com/> (last visited Feb. 7, 2020).

<sup>35</sup> Walker, *supra* note 32.

<sup>36</sup> *Id.* Not all Washington tribes are jumping on the cannabis bandwagon, however. In 2013, the Yakima Nation banned the growing, use, and sale of cannabis on its reservation and on off-reservation lands that it considers its historical territory. *Id.*

<sup>37</sup> NUWU CANNABIS MARKETPLACE, <https://nuwu.vegas/> (last visited Feb. 7, 2020).

<sup>38</sup> Walker, *supra* note 32.

opened the Tsaa Nesunkwa Dispensary in a more rural part of the state.<sup>39</sup> Outside of Washington and Nevada, where recreational cannabis is legal and the tribes operate dispensaries in accordance with tribal-state agreements,<sup>40</sup> tribal expansion into the cannabis industry has been more fraught. In 2015, for example, the Flandreau Santee Sioux Tribe became the first tribe to legalize recreational cannabis.<sup>41</sup> The tribe built a grow facility and was constructing a smoking lounge on its reservation in South Dakota (a state where cannabis is illegal),<sup>42</sup> but it burned its crop over concerns that state authorities would prosecute visitors once they left the reservation and that federal authorities might raid the tribe's cannabis facilities.<sup>43</sup> As more states relax cannabis laws, more tribes will no doubt be interested in entering the cannabis industry.<sup>44</sup>

### C. Federal Reaction to State and Tribal Legalization

As noted above, cannabis remains illegal under federal law.<sup>45</sup> Starting in 2009, however, the U.S. Department of Justice (DOJ), in series of memos to U.S. Attorneys, relaxed enforcement policies. The DOJ first advised that, while drug trafficking remained an important enforcement priority, federal prosecutorial resources should not focus “on individuals whose actions are in clear and unambiguous compliance with existing state laws providing for the medical use of marijuana.”<sup>46</sup>

In 2013, what has become known as the “Cole Memorandum” addressed enforcement of the CSA in an era of state decriminalization of recreational cannabis.<sup>47</sup> The Cole Memorandum noted that although Congress views cannabis as a dangerous substance, federal prosecution of small-scale cannabis sales should not be a priority where state law allows such sales via a tightly-

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<sup>39</sup> *Id.*; TSAA NESUNKWA DISPENSARY, <https://tsaanesunkwa.com/> (last visited Feb. 7, 2020).

<sup>40</sup> See *infra* Part V.C.2.

<sup>41</sup> Sarah S. Manning, *Flandreau Santee Sioux Tribe Burns Crop, Suspends Marijuana Operation*, INDIAN COUNTRY TODAY (Nov. 8, 2015), <https://indiancountrytoday.com/archive/flandreau-santee-sioux-tribe-burns-crop-suspends-marijuana-operation-C7jhlo3kiEqIhIUAZNQb5A>.

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> Some tribes have decided to grow industrial hemp. Walker, *supra* note 32. As previously noted, hemp is no longer a Schedule I controlled substance. See *supra* note 7.

<sup>45</sup> The CSA is a valid exercise of Congress' power over interstate commerce, even in “seed to sale” states (where cannabis is fully an intrastate activity) because the in-state use of cannabis could, in the aggregate, have a substantial impact on interstate commerce. *Gonzalez v. Raich*, 545 U.S. 1, 32-33 (2005).

<sup>46</sup> Memorandum from David W. Ogden, Deputy Att’y Gen., to Selected United States Attorneys, Investigations & Prosecutions in States Authorizing the Med. Use of Marijuana (Oct. 19, 2009), <https://www.justice.gov/archives/opa/blog/memorandum-selected-united-state-attorneys-investigations-and-prosecutions-states>.

<sup>47</sup> Memorandum from James M. Cole, Deputy Att’y Gen., to All United States Attorneys, Guidance Regarding Marijuana Enforcement (Aug. 29, 2013), <https://www.justice.gov/iso/opa/resources/3052013829132756857467.pdf> [hereinafter Cole Memorandum].

regulated market.<sup>48</sup> In 2014, the DOJ announced (in what has become known as the “Wilkinson Memorandum”) that the guidance in the Cole Memorandum would apply in Indian country.<sup>49</sup>

DOJ policy became less clear in 2018, when Attorney General Jeff Sessions rescinded the Cole and Wilkinson Memoranda.<sup>50</sup> Sessions essentially de-centralized the federal approach to cannabis—advising U.S. Attorneys to use “well-established” general principles for deciding when to prosecute.<sup>51</sup> Some U.S. Attorneys, overseeing districts where cannabis is legal, signaled that the status quo would continue.<sup>52</sup>

Beyond the DOJ’s statements, funding restrictions can stifle enforcement of the CSA. Under the Rohrabacher-Blumenauer Amendment,<sup>53</sup> the DOJ cannot spend funds to prevent states from “implementing their own State laws that authorize the use, distribution, possession or cultivation of medical marijuana.”<sup>54</sup> The Amendment does not apply to recreational cannabis.

## II. TAXATION OF THE CANNABIS INDUSTRY

As background for the tribal issues discussed later, this Part summarizes the general tax rules that apply to sales of cannabis. Section A reviews the federal income issues, including a provision (Section 280E) that disallows many business expenses of cannabis businesses. Section A also briefly reviews choice of entity issues in the cannabis industry. Section B then explains how the states, in general, tax the sale of cannabis.

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<sup>48</sup> *Id.*

<sup>49</sup> Memorandum from Monty Wilkinson, Dir. of the Exec. Office for U.S. Att’ys, to All United States Attorneys, All First Assistant United States Attorneys, All Criminal Chiefs, All Appellate Chiefs, All OCDETF Coordinators, & All Tribal Liaisons, Policy Statement Regarding Marijuana Issues in Indian Country (Oct. 28, 2014), <https://dfi.wa.gov/sites/default/files/monty-wilkinson-memo.pdf>.

<sup>50</sup> Memorandum from Jefferson B. Sessions, Att’y Gen., to All United States Attorneys, Marijuana Enforcement (Jan. 4, 2018), <https://www.justice.gov/opa/press-release/file/1022196/download>.

<sup>51</sup> *Id.*

<sup>52</sup> *E.g.*, Press Release, Dep’t of Just., U.S. Att’y’s Off., Dist. of Or., U.S. Attorney Statement on Marijuana Enforcement in the District of Oregon (Jan. 4, 2018), <https://www.justice.gov/usao-or/pr/us-attorney-statement-marijuana-enforcement-district-oregon> (pledging to “continue working with our federal, state, local and tribal law enforcement partners to pursue shared public safety objectives, with an emphasis on stemming the overproduction of marijuana and the diversion of marijuana out of state, dismantling criminal organizations and thwarting violent crime in our communities”).

<sup>53</sup> O’REILLY, *supra* note 2, at § 2:3.2.

<sup>54</sup> Consolidated and Further Continuing Appropriations Act of 2015, Pub. L. No. 113-235, § 538, 128 Stat. 2130 (2014).

## A. Federal Taxes

### 1. In General

Except as noted below, cannabis businesses are subject to federal income tax just like any other business. The U.S. Supreme Court has long held that income earned from illegal activities, such as the illegal sale of liquor during Prohibition, is taxable.<sup>55</sup>

Although many business expenses are deductible against income, taxpayers generally have no right to any specific deduction. “Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision thereof can any particular deduction be allowed.”<sup>56</sup> Congress provided a lot of grace in Section 162(a), which allows a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”<sup>57</sup> This is a broad category of deductions, which applies to businesses of all types (legal or illegal) provided no special rule applies and all the requirements (such as proper documentation and maintenance of books and records) are met.

### 2. Section 280E

One key difference between cannabis businesses and other (legal) businesses is that cannabis businesses cannot deduct many of their expenses; a result of Internal Revenue Code Section 280E:

**Expenditures in connection with the illegal sale of drugs.** No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.<sup>58</sup>

Congress enacted Section 280E, “more a political statement than a model of tax policy,”<sup>59</sup> in 1982 in response to *Edmondson v. Commissioner*.<sup>60</sup> In *Edmondson*, the U.S. Tax Court allowed a dealer in amphetamine, marijuana, and cocaine to deduct his estimated cost of goods sold, a portion of the rent on his residence, as well as “the purchase of a small scale, packaging

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<sup>55</sup> *United States v. Sullivan*, 274 U.S. 259, 263 (1927). *See also* *James v. United States*, 366 U.S. 213, 218 (1961) (noting that, since the early days of the income tax, it has been “a well-established principle . . . that unlawful, as well as lawful, gains are comprehended within the term ‘gross income.’”).

<sup>56</sup> *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

<sup>57</sup> I.R.C. § 162(a) (2018).

<sup>58</sup> I.R.C. § 280E (2018).

<sup>59</sup> Pat Oglesby, *How Bob Dole Got America Addicted to Marijuana Taxes*, BROOKINGS: FIXGOV (Dec. 18, 2015), <https://www.brookings.edu/blog/fixgov/2015/12/18/how-bob-dole-got-america-addicted-to-marijuana-taxes/> [hereinafter Oglesby, *Bob Dole*].

<sup>60</sup> T.C. Memo 1981-623.



expenses, telephone expenses, and automobile expenses” as ordinary and necessary business expenses.<sup>61</sup> The Staff of the Joint Committee on Taxation explained Section 280E’s rationale:

There is a sharply defined public policy against drug dealing. To allow drug dealers the benefit of business expense deductions at the same time that the U.S. and its citizens are losing billions of dollars per year to such persons is not compelled by the fact that such deductions are allowed to other, legal enterprises.<sup>62</sup>

Although not explicitly stated in the text of Section 280E, the Staff of the Joint Committee on Taxation noted that “[t]o preclude possible challenges on constitutional grounds,” the deduction for cost of goods sold was not included in the scope of Section 280E.<sup>63</sup> The constitutional issues concern the definition of income. Income is generally defined not as “gross receipts” but as gross receipts less the cost of goods sold.<sup>64</sup> Taxpayers engaged in the illicit drug trade are thus still allowed to deduct cost of goods sold.<sup>65</sup>

<sup>61</sup> For critical commentary on Section 280E, see Patrick J. Cleary, *The Good, the Bad, and the Ugly: Why IRC § 280E Is Not the Industry Killer It Is Portrayed to Be* (Moritz College of Law, Drug Enf’t and Policy Ctr., Working Paper No. 11, 2019), <https://ssrn.com/abstract=3440110> (noting that the cannabis industry continues to grow despite Section 280E and arguing that Section 280E actually helps the industry by slowing its growth and curbing oversaturation); Philip T. Hackney, *A Response to Professor Leff’s Tax Planning “Olive Branch” for Marijuana Dealers*, 99 IOWA L. REV. BULL. 25 (2014) (taking issue with Leff’s suggestion, *infra*, that cannabis dealers should be able to operate as tax-exempt entities); Kimberly A. Houser et al., *How Current Tax Policy Affects the Marijuana Industry*, 79 ST. TAX NOTES 583 (Feb. 22, 2016) (suggesting reforms to Section 280E); Douglas A. Kahn & Howard Bromberg, *Provisions Denying a Deduction for Illegal Expenses and Expenses of an Illegal Business Should Be Repealed*, 18 FLA. TAX REV. 207 (2016) (arguing for repeal of Section 280E and other disallowance provisions because they impose arbitrary penalties); Leff, *supra* note 31 (arguing that governments which legalize marijuana could choose to own the dispensaries, and thus be exempt from tax and the constraints of Section 280E); Benjamin Moses Leff, *Tax Planning for Marijuana Dealers*, 99 IOWA L. REV. 523 (2014) (arguing that cannabis businesses should be allowed to operate as nonprofit, Section 501(c)(4) organizations and thus avoid Section 280E) [hereinafter Leff, *Tax Planning*]; Edward J. Roche, Jr., *Federal Income Taxation of Medical Marijuana Businesses*, 66 TAX LAW. 429 (2013) (analyzing Section 280E and the inventory accounting rules in the context of recent cases). See also Douglas A. Kahn & Howard Bromberg, *Prompt on the Tax Treatment of a Marijuana Business*, 8 COLUM. J. TAX L. TAX MATTERS 2 (Aug. 7, 2019); Zachary Pullin, *Dude, Where’s My Deduction* 8 COLUM. J. TAX L. TAX MATTERS 2 (Aug. 7, 2019) (various comments on Section 280E and related issues); Kenneth H. Silverberg, *“Reverse Al Capone-ism” and the Tax Treatment of Marijuana Businesses*, 8 COLUM. J. TAX L. TAX MATTERS 2 (Aug. 7, 2019) (the three previous citations are a part of one collective work that can be found at <https://journals.library.columbia.edu/index.php/taxlaw/announcement/view/139#kahnbro>; Oglesby, *Bob Dole*, *supra* note 59 (discussing how Section 280E, by disallowing deductions—including deductions for advertising, is a tool to reduce advertising of marijuana).

<sup>62</sup> STAFF OF THE J. COMM. ON TAX’N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982 (H.R. 4961, 97th Congress; P.L. 97-248), at 264 (1982).

<sup>63</sup> *Id.* at 264.

<sup>64</sup> *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 184-85 (1918).

<sup>65</sup> While the tax law’s Section 263A uniform capitalization rules (UNICAP) require businesses to capitalize many expenses in inventory (and thus cost of goods sold), cannabis businesses may be limited in their ability to aggressively classify more expenses as deductible cost of goods. Taxpayers cannot capitalize nondeductible costs in inventory: “Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.” I.R.C. § 263A(a)(2) (2018) (flush language).

### 3. Section 280E in Court

As dispensaries migrate from the illegal, black market world of drug dealers to the quasi-legal, “gray market” world of state-regulated dispensaries,<sup>66</sup> they are complying with state regulations, keeping accurate accounting records, and openly reporting their activities to the tax authorities. The increased salience of the cannabis industry has attracted the attention of the Internal Revenue Service (IRS), which has been enforcing Section 280E.<sup>67</sup> Dispensaries have pushed back, with little success.

The courts, for example, have ruled that Section 280E is not a “dead letter” just because states have legalized certain uses of cannabis and the federal government is not rigorously enforcing its ban on the sale of cannabis.<sup>68</sup> Indeed, the courts have repeatedly held that selling cannabis in states where it is legal is still “trafficking” as stated in Section 280E<sup>69</sup> and that Section 280E disallows *all* of a dispensary’s deductions (except cost of goods sold), not just ordinary and necessary business expenses under Section 162.<sup>70</sup> Furthermore, the courts have ruled that the IRS has the authority to apply Section 280E without first conducting a criminal investigation of the taxpayer.<sup>71</sup> The courts have also not been kind to constitutional challenges, holding that Section 280E is not a penalty for purposes of the Eight Amendment’s ban on excessive fines<sup>72</sup> and is within Congress’s power to tax income under the Sixteenth Amendment.<sup>73</sup> Also, the courts have held that placing the burden of proof on taxpayers to show that the IRS erred in applying Section 280E does not violate the Fifth Amendment’s privilege against self-incrimination.<sup>74</sup>

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<sup>66</sup> See *Gray-Market*, *supra* note 2, at 1.

<sup>67</sup> Section 280E is estimated to increase federal coffers by about \$1.3 billion per year starting in 2020. Pat Oglesby, *Marijuana Taxes—Present and Future Traps*, 83 ST. TAX NOTES 391, 391, (Jan. 31, 2017) [hereinafter Oglesby, *Traps*].

<sup>68</sup> See, e.g., *High Desert Relief, Inc. v. United States*, 917 F.3d 1170, 1197 (10th Cir. 2019); *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1206 (10th Cir. 2018), *cert. denied* 139 S.Ct. 2745 (2019).

<sup>69</sup> E.g., *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. No. 4, at \*15 (2019); *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 190 (2018); *Canna Care, Inc. v. Comm’r*, T.C. Memo 2015-206, at \*9, *aff’d* 694 Fed. Appx. 570 (9th Cir. 2017) (unpublished); *Olive v. Comm’r*, 139 T.C. 19, 38 (2012) *aff’d* 792 F.3d 1146 (9th Cir. 2015); *Californians Helping to Alleviate Med. Problems, Inc. v. Comm’r*, 128 T.C. 173, 182-83 (2007).

<sup>70</sup> *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. No. 4 (2019), at \*13-15 (ruling that a medical marijuana dispensary was not entitled to deductions under Section 164 (taxes) and Section 167 (depreciation)).

<sup>71</sup> *High Desert Relief, Inc. v. United States*, 917 F.3d 1170, 1185 (10th Cir. 2019). See also *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1196-97 (10th Cir. 2018), *cert. denied* 139 S.Ct. 2745 (2019) (indicating that a criminal investigation or conviction is not a prerequisite to applying Section 280E); *The Green Sol. Retail, Inc. v. United States*, 855 F.3d 1111, 1120-21 (10th Cir. 2017), *cert. denied* 138 S.Ct. 1281 (2018) (same).

<sup>72</sup> *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1202 (10th Cir. 2018), *cert. denied* 139 S.Ct. 2745 (2019); *N. Cal. Small Bus. Assistants, Inc. v. Comm’r*, 153 T.C. No. 4 (2019), at \*9. Since deductions are a matter of legislative grace, “Congress is free to grant, restrict, and deny deductions as it sees fit,” and thus a denial of a deduction, like Section 280E, cannot be construed as a penalty. *Id.* at \*3.

<sup>73</sup> *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1202 (10th Cir. 2018), *cert. denied* 139 S.Ct. 2745 (2019).

<sup>74</sup> *Feinberg v. Comm’r*, 916 F.3d 1330, 1336 (10th Cir. 2019), *cert. denied* 140 S.Ct. 49 (2019).

The courts have also dismissed challenges to the application of Section 280E based on its use of the phrase “consists of trafficking.”<sup>75</sup> “Consists of,” taxpayers have argued based on dictionary definitions, implies exclusivity.<sup>76</sup> But the U.S. Tax Court ruled that Section 280E applies even if the business does things (like selling books or clothing) besides traffic in a controlled substance.<sup>77</sup>

Some dispensaries have tried to divide their activities into cannabis and non-cannabis components, which would allow them to deduct expenses related to the latter. In *Californians Helping to Alleviate Medical Problems, Inc. v. Commissioner (CHAMP)*,<sup>78</sup> the U.S. Tax Court found that a medical marijuana dispensary operated two lines of business: marijuana sales and caregiving services. CHAMP’s regular and extensive non-cannabis caregiving business (like discussion groups, counseling, social events, field trips, and social services) “stood on its own, separate and apart from [CHAMP’s] provision of medical marijuana.”<sup>79</sup> The court allowed CHAMP to allocate its expenses between the two businesses based on the number of employees and space assigned to each and deduct the expenses of the non-cannabis operations.<sup>80</sup> CHAMP is an outlier. The U.S. Tax Court has refused to allow bifurcation in several subsequent cases, holding that any non-cannabis operations were too connected to the cannabis sales.<sup>81</sup> Litigation will no doubt continue, but the message from the courts is that Section 280E is valid. It is difficult for dispensaries to carve out their non-cannabis businesses to partially avoid Section 280E, and even those that are able to do so must bear the administrative burden of keeping separate records and perhaps operating the businesses in suboptimal ways.

#### 4. Entity Choice

A cannabis business’s choice of entity impacts how it is taxed. Corporations (“C” corporations) are subject to tax at a flat 21% rate at the entity level.<sup>82</sup> Distributions of earnings to shareholders are generally taxed a second time, as dividends,<sup>83</sup> when received by the shareholders.<sup>84</sup>

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<sup>75</sup> The most extensive analysis of this issue was by the U.S. Tax Court in *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 190-97 (2018).

<sup>76</sup> *Id.*

<sup>77</sup> *Id.* at 196-97. The court noted that accepting the taxpayer’s argument would be absurd: “any street-level drug dealer could circumvent [Section 280E] by selling a single item that wasn’t a controlled substance—like a pack of gum, or even drug paraphernalia such as a hypodermic needle or a glass pipe.” *Id.* at 192.

<sup>78</sup> 128 T.C. 173 (2007).

<sup>79</sup> *Id.* at 183.

<sup>80</sup> *Id.* at 185.

<sup>81</sup> *Alt. Health Care Advocates v. Comm’r*, 151 T.C. 225 (2018); *Patients Mut. Assistance Collective Corporation v. Comm’r*, 151 T.C. 176 (2018); *Canna Care, Inc. v. Comm’r*, T.C. Memo 2015-206, *aff’d* 694 Fed. Appx. 570 (9th Cir. 2017) (unpublished); *Olive v. Comm’r*, 139 T.C. 19 (2012) *aff’d* 792 F.3d 1146 (9th Cir. 2015).

<sup>82</sup> I.R.C. § 11(b) (2018).

<sup>83</sup> To the extent the corporation had earnings and profits, the distribution is taxed as a dividend. *See* I.R.C. §§ 301(c)(1), 316 (2018).

<sup>84</sup> Shareholders who are individuals may qualify to pay tax on dividends at the capital gains tax rates (0%, 15%, or 20%, depending on income). I.R.C. § 1(h)(11) (2018).

Individuals are subject to progressive tax rates currently ranging from 10% to 37%.<sup>85</sup> Conduit entities, like partnerships (a category which normally includes Limited Liability Companies) and S Corporations, do not generally pay tax at the entity level. Instead, they allocate their income among their owners—who then report the income on their own tax returns.<sup>86</sup>

Nonprofits are also present in the cannabis industry. Under state law, many entities in the medical cannabis market must be set up as nonprofit corporations—meaning any earnings must go to benefit patients or the community and not the owners or founders.<sup>87</sup> Despite their nonprofit missions, such entities are still taxed as corporations by the federal government. The entities cannot qualify for federal tax-exempt status because they are involved in illegal activity.<sup>88</sup>

Sub-federal (tribal and state) governments, which are generally exempt from federal income tax,<sup>89</sup> may also enter the cannabis industry. Indian tribes have entered the market, but state and local governments, with isolated exceptions, have not.<sup>90</sup>

If cannabis is legalized at the federal level, there may be a shift in preferences for entities. For example, it might become possible for nonprofit medical dispensaries to obtain tax-exempt status. With the cloud of illegality removed, more sub-federal governments may decide to enter the industry directly—as is the case with alcohol in some states.

## B. State Taxes

One of the reasons states are legalizing recreational<sup>91</sup> cannabis is to tax it.<sup>92</sup> Total annual state tax revenues from recreational cannabis have grown from approximately \$24 million in 2014 to \$987 million in 2018.<sup>93</sup> From 2014 to 2018, states took in over \$2.9 billion in cumulative

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<sup>85</sup> I.R.C. § 1 (2018).

<sup>86</sup> I.R.C. § 701 (2018) (partnerships); I.R.C. §§ 1363(a), 1366 (2018) (S corporations).

<sup>87</sup> This is the case in California, for example. *Patients Mut. Assistance Collective Corp. v. Comm’r*, 151 T.C. 176, 182 (2018).

<sup>88</sup> See, e.g. Rev. Rul. 75-384, 1975-2 C.B. 204 (holding that an anti-war organization could not qualify under Section 501(c)(3) because it was engaged in illegal activities of blocking traffic and disrupting the transportation of supplies). But see Leff, *Tax Planning*, *supra* note 61 (arguing that cannabis dispensaries should be allowed tax-exempt status as “social welfare organizations” under I.R.C. § 501(c)(4) (2018)).

<sup>89</sup> See *infra* Part III.B.1.

<sup>90</sup> See Leff, *Government-Owned*, *supra* note 31 (reporting on a cannabis store in North Bonneville, Washington, which is owned by an entity created by the city government).

<sup>91</sup> Although some states that only allow medical cannabis impose a tax on it, it is generally only an extension of its sales tax and it tends to raise little revenue. See Sarah Trumble & Nathan Kasai, *How States Tax Medical Marijuana*, THIRD WAY, (Mar. 23, 2017), <https://www.thirdway.org/one-pager/how-states-tax-medical-marijuana>.

<sup>92</sup> See O’REILLY, *supra* note 2, at §8.1. Excellent analysis of state tax design has been done by tax attorney Pat Oglesby. E.g., Pat Oglesby, *Marijuana Revenue Competition—Look Out Below*, 88 ST. TAX NOTES 541 (May 7, 2018) [hereinafter Oglesby, *Look Out*]; Oglesby, *Traps*, *supra* note 67. Research institutions have also provided excellent analysis of the state taxation of cannabis. E.g., Lucy Dadayan, *Are States Betting on Sin? The Murky Future of State Taxation*, URBAN INSTITUTE (Oct. 8, 2019), [https://www.urban.org/research/publication/are-states-betting-sin-murky-future-state-taxation/view/full\\_report](https://www.urban.org/research/publication/are-states-betting-sin-murky-future-state-taxation/view/full_report); The Pew Charitable Trusts, *Forecasts Hazy for State Marijuana Revenue*, PEW (Aug. 19, 2019), <https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2019/08/forecasts-hazy-for-state-marijuana-revenue>; Carl Davis et al., *Taxing Cannabis*, INSTITUTE ON TAXATION & ECONOMIC POLICY (Jan. 23, 2019), <https://itep.org/taxing-cannabis/> [hereinafter *Taxing Cannabis*].

<sup>93</sup> Dadayan, *supra* note 92, at 48.

revenues from recreational cannabis.<sup>94</sup> While the potential revenue is enticing, it can be volatile—especially as incomes change, tastes evolve, and more states legalize recreational cannabis.<sup>95</sup> Some have even predicted that cannabis tax revenue could disappear if the federal government legalizes and taxes cannabis or if a sufficient number of states legalize and start a low-tax race to the bottom as they compete for cannabis businesses.<sup>96</sup>

Most states tax cannabis using an excise tax based on the sales price.<sup>97</sup> This can be done at the sale from the cultivator/wholesaler to the retailer, the sale from the retailer to the consumer, or both.<sup>98</sup> The cultivator/wholesaler tax is similar to alcohol taxes, and the cost tends to get passed along/hidden in the price of the product to the consumer.<sup>99</sup> Retail excise taxes, currently ranging from 10% in Nevada to 37% in Washington, are akin to retail sales taxes.<sup>100</sup> Some states apply both their normal retail sales tax and a retail excise tax to cannabis sales.<sup>101</sup> In addition, states often allow local jurisdictions to impose their general sales taxes or a cannabis-specific retail excise tax on cannabis sales.<sup>102</sup>

Other states tax cannabis based on its weight. Alaska, for example, taxes mature flowers at \$50 per ounce.<sup>103</sup> Alaska currently only taxes by weight and not sales price.<sup>104</sup> California taxes based on sales price and weight.<sup>105</sup>

Despite all the state excise taxes being thrown at the industry, some states are giving legal cannabis businesses relief on their state income tax returns. Most states begin their income tax calculations with a business's federal taxable income and then make adjustments to get to the business's state taxable income. States like Colorado and Oregon are allowing businesses, in calculating their state taxable income, to deduct any businesses expenses that were disallowed by Section 280E at the federal level.<sup>106</sup>

Overall, state taxes on cannabis must be calibrated so that they raise revenue without being so high that they push buyers into the black market.<sup>107</sup> As the industry matures, states will

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<sup>94</sup> *Id.* at 49.

<sup>95</sup> Gillers, *supra* note 14.

<sup>96</sup> Oglesby, *Traps*, *supra* note 67, at 398-99.

<sup>97</sup> Dadayan, *supra* note 92, at 45-46.

<sup>98</sup> *Id.*

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> *Id.* at 46.

<sup>104</sup> *Id.*

<sup>105</sup> *Id.*

<sup>106</sup> See COL. REV. STAT. § 39-22-104(4)(r)-(s) (2019); OR. REV. STAT. § 316.680(1)(i) (2019). States that allow deductions that were disallowed at the federal level by Section 280E are providing cold comfort. State income tax rates are a fraction of federal income tax rates and, thus, the pain of Section 280E is much more significant at the federal level than at the state level.

<sup>107</sup> Gillers, *supra* note 14. It is estimated that the black market is about \$40 billion nationwide and that legal marijuana flowers cost 77% more than illegal ones in California. *Id.*

no doubt experiment with changes to their tax regimes. State taxation of cannabis will continue to be a subject of debate and recalibration.

### III. THE TAX LANDSCAPE IN INDIAN COUNTRY

To understand the tax issues posed by cannabis legalization on Indian reservations, this Part provides an overview of the tax landscape in Indian country. Section A reviews the legal status of Indian tribes. Section B then explains how the federal tax law applies to Indian tribes and tribal members. Finally, Section C discusses sub-federal (tribal and state) taxation in Indian country.<sup>108</sup>

#### A. Legal Status of American Indian Tribes

The Native American community is not a monolith. There are 573 federally recognized tribes in the United States, each with its own culture, traditions, history, government, and economic status.<sup>109</sup> Indian tribes occupy a unique position in American law. Along with the federal government and the state governments, Indian tribes are considered sovereign entities.<sup>110</sup> Tribes, while governmental entities, are not considered “states” or “foreign nations” for most purposes of the law.<sup>111</sup>

Under the Indian Commerce Clause of the U.S. Constitution, the federal government has exclusive power over Indian tribes.<sup>112</sup> States may only exercise authority on tribal lands within their borders if federal law so provides. Consider the implications of this structure. Each Indian reservation is generally located within the borders of a particular state (or states).<sup>113</sup> In that sense, tribes are like local governments—such as cities, towns, or counties. But local governments do not have sovereignty. They only have the power (including taxing power) that has been

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<sup>108</sup> For more detail, see Mark J. Cowan, *Tax Issues in Indian Country: A Guide for Practitioners*, 106 J. TAX’N 296 (2007) (providing a basic introduction to tax issues in Indian country); Mark J. Cowan, *Double Taxation in Indian Country: Unpacking the Problem and Analyzing the Role of the Federal Government in Protecting Tribal Governmental Revenues*, 2 PITT. TAX REV. 93 (2005) (analyzing the background of state/tribal tax conflicts and proposing a federal solution); Mark J. Cowan, *Leaving Money on the Table(s): An Examination of Federal Income Tax Policy Towards Indian Tribes*, 6 FLA. TAX REV. 345 (2004) [hereinafter Cowan, *Leaving Money*] (reviewing the federal tax treatment of the commercial income of tribes and comparing such treatment to the federal taxation of commercial income earned by state governments).

<sup>109</sup> See *Frequently Asked Questions*, U.S. DEP’T OF THE INTERIOR, INDIAN AFF., <https://www.bia.gov/frequently-asked-questions> (last visited Apr. 7, 2020); *About Tribes*, NAT’L CONG. OF AMERICAN INDIANS, <http://www.ncai.org/about-tribes> (last visited Apr. 7, 2020). This article only addresses tribes that are officially recognized by the federal government.

<sup>110</sup> Upon arriving in America, the European powers implicitly acknowledged tribal sovereignty by dealing with the tribes as they would other foreign governments and leaving the tribes to govern their own internal affairs. WILLIAM C. CANBY, JR., *AMERICAN INDIAN LAW* 76 (5th ed. 2009); see also COHEN’S HANDBOOK, *supra* note 3, at § 4.01.

<sup>111</sup> *Cherokee Nation v. Georgia*, 30 U.S. 1, 19 (1831).

<sup>112</sup> Under the Indian Commerce Clause, one of Congress’s enumerated powers is to “regulate Commerce . . . with the Indian Tribes.” U.S. CONST. art. I, § 8, cl. 3. The U.S. Supreme Court has interpreted this clause as vesting exclusive power over the Indian tribes in the federal government. See *Cherokee Nation*, 30 U.S. at 19.

<sup>113</sup> The Navajo Nation, for example, spans parts of Utah, Arizona, and New Mexico. *History*, NAVAJO NATION GOV’T, <https://www.navajo-nsn.gov/history.htm> (last visited Apr. 7, 2020).

delegated to them by the true sovereign—the state in which they are located.<sup>114</sup> The state has ultimate responsibility for local affairs, even though in practice it may allow a lot of autonomy and power to reside at the local level. Any state versus local dispute can ultimately be resolved using state power. Unlike local governments, tribes have inherent sovereignty over local affairs and do not owe their power to the state in which they are located.<sup>115</sup> Thus, tribes and states are bound together *geographically* but not *politically*. States and tribes must work together on local issues, but neither has significant authority over the other.<sup>116</sup> State-tribal disputes over local matters—like taxes or cannabis—can only be resolved by state-tribal agreement or by the intervention of the one government with the ultimate power over Indian affairs—the federal government.<sup>117</sup>

The goals of federal policy towards Indian tribes have varied over the years, but current federal Indian policy emphasizes tribal self-government and self-determination.<sup>118</sup> If Indian tribes are to be truly self-sufficient, they must develop sophisticated governments with steady revenue streams that can fund needed services. Realistically, this can only occur with economic development in Indian country.<sup>119</sup> Some tribes eschew commercial ventures of their own, relying on non-Indians to come on to the reservation, operate businesses that provide jobs, and pay taxes that fund the tribal government.<sup>120</sup> Other tribes focus on developing commercial operations of their own to provide jobs and provide revenue (via profits) to the tribal treasury.<sup>121</sup> Some tribes combine these two approaches.<sup>122</sup>

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<sup>114</sup> Michael A. Pagano, “*The Third Rail*”: *Local Governments and Taxing Espresso*, 2003 ST. TAX TODAY 297-7, Oct. 27, 2003 (indicating that local governments, “as creatures of their states, exercise fiscal authority differently depending on what the state allows”).

<sup>115</sup> See CANBY, *supra* note 110, at 71.

[A] tribe is quite unlike a city or other subdivision of a state. When a question arises as to the power of a city to enact a particular regulation, there must be some showing that the state has conferred such power on the city; the state, not the city, is the sovereign body from which power must flow. A tribe, on the other hand, is its own source of power . . . the tribe is sovereign.

*Id.*

<sup>116</sup> Blackstone, worried about papal interference in England, warned against such an “*imperium in imperio* [a government within a government].” 4 WILLIAM BLACKSTONE, COMMENTARIES \*114.

<sup>117</sup> As noted earlier, the federal government has exclusive power over the Indian tribes under the U.S. Constitution. And federal law is supreme to state law when the federal government is acting within the authority delegated to it by the U.S. Constitution. U.S. CONST. art. VI, cl. 2.

<sup>118</sup> For a history of federal Indian policy, see CANBY, *supra* note 110, at 12-34.

<sup>119</sup> See *California v. Cabazon Band of Mission Indians*, 480 U.S. 202, 216 (1987) (where the Court noted the federal government’s “‘overriding goal’ of encouraging tribal self-sufficiency and *economic development*”) (emphasis added); 25 U.S.C. § 2701(4) (2018) (noting a congressional finding that “a principal goal of Federal Indian policy is to promote tribal economic development, tribal self-sufficiency, and strong tribal government”).

<sup>120</sup> The Navajo Nation generally follows this model. The tribe collected approximately \$109 million in taxes in fiscal 2018. OFF. OF THE NAVAJO TAX COMM’N, <https://www.tax.navajo-nsn.gov/> (last visited Mar. 10, 2020).

<sup>121</sup> Since 1934, federal law has encouraged tribes to establish their own business operations. In that year, Congress passed the Indian Reorganization Act (codified at 25 U.S.C. §§ 461-79) which was designed to “permit Indian tribes to equip themselves with the devices of modern business organization, through forming themselves into business corporations.” S. REP. NO. 73-1080, at 1 (1934).

<sup>122</sup> For example, a tribe could open a cannabis dispensary and collect both profits and taxes on sales to customers.

For those tribes that choose to start their own businesses, the most obvious example is the operation of tribal casinos.<sup>123</sup> Tribes also run hotels, timber operations, restaurants, manufacturing plants, industrial parks, smoke shops, professional sports franchises, gas stations<sup>124</sup> and, of course, cannabis stores.<sup>125</sup>

## B. Federal Taxation in Indian Country

### 1. Federal Income Taxation

**Tribes.** Per IRS guidance since 1967, Indian tribes are not subject to the federal income tax on any activities that they undertake directly<sup>126</sup> or through a federally-chartered Indian corporation.<sup>127</sup> The exemption covers income from all tribal undertakings, regardless of whether they are governmental or commercial in nature<sup>128</sup> and regardless of whether such activities are conducted on or off the reservation.<sup>129</sup> The broad exemption from the federal income tax enjoyed by Indian tribes is the product of long-standing, sometimes mysterious IRS policy rather than the product of specific provisions of the Internal Revenue Code.<sup>130</sup> While there are no definitive rulings on point, the exemption granted to tribes does not appear to be required by the U.S. Constitution.<sup>131</sup>

The exemption for tribes is broad but is subject to exceptions. Importantly, the activities a tribe conducts via a state-chartered corporation are subject to the federal income tax.<sup>132</sup> Less importantly, the commercial (non-educational) income of tribal colleges and universities are subject to the federal corporate income tax via the unrelated business income tax (UBIT),<sup>133</sup> which generally applies to the commercial income of charities and state colleges and universities.<sup>134</sup>

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<sup>123</sup> See *infra* Part IV.

<sup>124</sup> E.g., Richard J. Ansson, Jr. & Ladine Oravetz, *Tribal Economic Development: What Challenges Lie Ahead for Tribal Nations as They Continue to Strive for Economic Diversity?*, 11 KAN. J.L. & PUB. POL'Y 441, 445 (2002) (listing typical tribal business ventures); Margaret Graham Tebo, *Betting on Their Future*, ABA J. May 2006, at 33 (discussing the legal issues surrounding the Tulalip Tribe's new shopping mall in Washington state). See generally *Sun*, WOMEN'S NAT'L BASKETBALL ASS'N, <http://www.wnba.com/sun/> (website of the Women's National Basketball Association team the Connecticut Sun, acquired by the Mohegan tribe in 2003).

<sup>125</sup> See *supra* Part I.B.

<sup>126</sup> Rev. Rul. 67-284, 1967-2 C.B. 55.

<sup>127</sup> Rev. Rul. 81-295, 1981-2 C.B. 15.

<sup>128</sup> See *id.*

<sup>129</sup> Rev. Rul. 94-16, 1994-1 C.B. 19.

<sup>130</sup> While the Code does not directly address the income taxation of Indian tribes, I.R.C. § 7871 (2018) does treat tribes as states for certain enumerated purposes. For example, taxes paid to Indian tribal governments are deductible in the same manner as taxes paid to states under § 164.

<sup>131</sup> For more detail, see Cowan, *Leaving Money*, *supra* note 108, at 383-88.

<sup>132</sup> Rev. Rul. 94-16, 1994-1 C.B. 19. The result is logical, as the activities of the tribe conducted via a state-chartered corporation would fall squarely under the federal tax on the taxable income of corporations in I.R.C. § 11 (2018).

<sup>133</sup> I.R.C. § 7871(a)(5) (2018).

<sup>134</sup> I.R.C. § 511(a)(2) (2018).



Exempting tribes from the federal income tax may at first glance appear unfair. But recall that tribes are governments. And other sub-federal governments, like states, are generally not subject to the federal income tax.<sup>135</sup>

**Tribal Members.** With a few exceptions,<sup>136</sup> individual tribal members *are* subject to the federal income tax like all other citizens of the United States.<sup>137</sup> Others (nonmembers of the tribe) doing business on Indian reservations are generally subject to federal tax in the same manner as when they operate elsewhere.<sup>138</sup>

In recent years, issues have cropped up over whether certain tribal government payments to tribal members are taxable. The IRS has long recognized a “general welfare exclusion” for certain benefits received by individuals from the government (be it federal, state, local, or tribal).<sup>139</sup> To qualify for this exclusion, the payment must be made under a government program, be based on need, and not be compensation for services.<sup>140</sup> Tribal governments often pay members for a greater variety of benefits than other governments.<sup>141</sup> Tribes may provide assistance with housing, elder care, and education.<sup>142</sup> Tribes will also often help low-income members purchase supplies for traditional ceremonies, feasts, and rituals.<sup>143</sup>

When Native American advocacy groups noted that the IRS was claiming that many tribal payments to members fell outside the general welfare exclusion,<sup>144</sup> Congress enacted the Tribal General Welfare Exclusion Act of 2014 (GWE).<sup>145</sup> Under the GWE, benefits members receive from the tribal government are not taxable if they are administered under a program with specified guidelines, promote general welfare, are available to all members who meet the guidelines, are not lavish or extravagant, are not compensation for services, and do not

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<sup>135</sup> Income “accruing to the government of any possession of the United States, or any political subdivision thereof” is not taxable. I.R.C. § 115 (2018). Since 1935, the IRS’s position has been that, even if Section 115 did not exist, states would still not be taxed on any income they earn directly because they are beyond the scope of the federal income tax as neither corporations nor individuals. Rather, the IRS views Section 115 as exempting income earned by subdivisions of states where the income earned ultimately accrues to the state treasury. GEN. COUNS. MEM. 14,407, 1935-1 C.B. 103,107 (Jan. 28, 1935). Technically, the GCM was superseded by Rev. Rul. 71-131, 1971-1 C.B. 28. Rev. Rul. 71-131, however, reached the same conclusion as the GCM, only without any legal analysis.

<sup>136</sup> The exceptions are relatively narrow, dealing with income from “allotted lands” held in trust for the tribal members by the federal government (see Rev. Rul. 67-284, 1967-2 C.B. 55) and income earned from fishing rights granted by a treaty (see I.R.C. § 7873 (2018)).

<sup>137</sup> *Squire v. Capoeman*, 351 U.S. 1, 5 (1956).

<sup>138</sup> Businesses operating on Indian reservations, however, may be eligible for (temporary but periodically-extended) employment tax credits and accelerated depreciation. I.R.C. § 45A (2018) (Indian employment tax credit); I.R.C. § 168(j) (2018) (accelerated depreciation).

<sup>139</sup> See, e.g., Rev. Proc. 2014-35, 2014-26 I.R.B. 1110.

<sup>140</sup> *Id.*

<sup>141</sup> Kat Lucero, *Tribes Await General Welfare Clarity*, *New Advisory Committee*, 2015 TAX NOTES TODAY 232-3, Dec. 3, 2015.

<sup>142</sup> *Id.*

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> I.R.C. § 139E (2018).

discriminate in favor of tribal leaders.<sup>146</sup> The GWE also provides that payments for participating in cultural or ceremonial activities would not be considered compensation for services.<sup>147</sup>

While the GWE solved one tax problem, it created another. Certain tribes and tribal members interpreted the GWE as excluding distributions of gaming profits from taxation.<sup>148</sup> Congress had expressly made such distributions taxable in 1988.<sup>149</sup> Litigation ensued over whether the GWE had made distributions of gaming profits exempt from tax.<sup>150</sup> The Eleventh Circuit ruled that the GWE did not exempt distributions of gaming profits.<sup>151</sup>

## 2. Federal Excise Taxes

While the federal income tax rules are fairly clear, the federal excise tax picture in Indian country is cloudy. The federal government imposes a variety of excise taxes.<sup>152</sup> The tax base may be price or quantity. Taxes on products (like fuel, alcohol, or cigarettes) are generally imposed on the manufacturer/producer when the product is removed from inventory to the next stage in the supply chain.<sup>153</sup> Taxes on services (like wagering) are generally imposed on the service provider (like a casino) at the time the service is rendered.<sup>154</sup> Unlike retail sales taxes, excise taxes are usually built into the price of the product.<sup>155</sup>

State governments are either explicitly exempt from many federal excise taxes by statute<sup>156</sup> or tend not to engage in the taxed activities.<sup>157</sup> Tribes are explicitly exempt from many of the same federal excise taxes as states.<sup>158</sup> But, unlike states, tribes are only exempt if the

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<sup>146</sup> *Id.*

<sup>147</sup> I.R.C. § 139E(c)(5) (2018).

<sup>148</sup> *E.g.*, *United States v. Jim*, 891 F.3d 1242 (11th. Cir. 2018).

<sup>149</sup> See *infra* Part IV.

<sup>150</sup> *United States v. Jim*, 891 F.3d 1242 (11th. Cir. 2018).

<sup>151</sup> *Id.* at 1251.

<sup>152</sup> Federal excise taxes can be found in Subtitles D and E of the Internal Revenue Code.

<sup>153</sup> *E.g.*, I.R.C. §§ 4081-4105 (2018) (fuel taxes); I.R.C. §§ 5001-5872 (2018) (taxes on alcohol); I.R.C. §§ 5701-5763 (2018) (taxes on tobacco/cigarettes).

<sup>154</sup> *E.g.*, I.R.C. § 4401 (2018) (imposing a 0.25 percent excise tax on every wager to be paid by “each person who is engaged in the business of accepting wagers”).

<sup>155</sup> There are exceptions. The tax on air transportation, for example, is paid by the ticket purchaser/passenger and is usually displayed on their receipt from the airline. See I.R.C. § 4261 (2018).

<sup>156</sup> *E.g.*, I.R.C. § 4253(i) (2018) (exempting state and local governments from the communications/phone excise tax); I.R.C. § 4402(3) (2018) (exempting state-conducted lotteries and certain other gaming activity from the excise tax on wagering).

<sup>157</sup> For example, there appears to be no explicit exemption for state governments that engage in manufacturing cigarettes, but there do not appear to be any state governments which do so.

<sup>158</sup> See, e.g., I.R.C. § 7871(a)(2) (2018) (treating tribes like states in determining exemptions from federal excise taxes on special fuels, certain manufacturing activities, communications/phone, and the use of certain highway vehicles). Tribes also have special exemptions in certain cases. See, e.g., I.R.C. § 4225 (2018) (exempting “any article of native Indian handicraft manufactured or produced by Indians on Indian reservations” from excise taxes on manufacturers).

transaction at issue “involves the exercise of an essential governmental function.”<sup>159</sup> Thus, the federal excise tax exemption picture for tribes is a fuzzy one—which leads to misunderstandings and litigation. It is not clear, for example, to what extent gaming (which provides funds to tribal governments) is an essential governmental function (even though states do it too),<sup>160</sup> let alone cannabis.

As further illustration of the uncertainty, consider the federal excise tax on wagering. States are explicitly exempt from this tax,<sup>161</sup> while tribes are not.<sup>162</sup> Tribes, based on their interpretation of laws on Indian gaming, have argued that they should be exempt from the wagering tax.<sup>163</sup> The uncertainty resulted in litigation that culminated in the U.S. Supreme Court ruling that tribes were not exempt from the tax.<sup>164</sup>

### C. Sub-Federal Taxation in Indian Country

#### 1. Important Distinctions

In discussing tribal and state tax issues in Indian country, two important distinctions must be understood. The first is the difference between tribal “members” and “nonmembers.” An individual is a member of a tribe if he/she is listed on the membership roll of the tribe controlling the reservation on which he/she resides or does business. All others, including non-Indians *and members of other Indian tribes*, are considered nonmembers.<sup>165</sup>

The second is the difference between the legal and economic incidence of a tax. The “incidence” of a tax refers to the person or entity upon whom the tax falls.<sup>166</sup> The *legal* incidence is usually clear: it is the party the tax statute specifies as being responsible for actually paying the tax to the government. If the tax is not paid, the government will attempt to collect the tax from the party with the legal incidence. In doing so, the government may impose penalties on that party and, if necessary, seize that party’s assets to satisfy the tax bill. With the federal corporate income tax, for example, the legal incidence is on the corporation itself.<sup>167</sup>

The *economic* incidence falls on the person or entity that actually suffers economically because of the tax. Corporations, for example, do not bear the economic incidence of the corporate income tax.<sup>168</sup> They pass it along to customers (via charging higher prices for outputs), suppliers (via paying lower prices for inputs), workers (via paying lower wages), or investors

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<sup>159</sup> I.R.C. § 7871(b) (2018).

<sup>160</sup> See COHEN’S HANDBOOK, *supra* note 3, at § 8.02[2][d].

<sup>161</sup> I.R.C. § 4402(3) (2018).

<sup>162</sup> See I.R.C. § 7871(a)(2) (2018) (*not* listing wagering taxes among those for which a tribe would be treated like a state for exemption purposes).

<sup>163</sup> See *infra* Part IV.

<sup>164</sup> *Chickasaw Nation v. United States*, 534 U.S. 84 (2001).

<sup>165</sup> See, e.g., *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134, 161 (1980) (noting that members of tribes other than the tribe governing the reservation “stand on the same footing as non-Indians resident on the reservation”).

<sup>166</sup> RICHARD WESTIN, WG&L TAX DICTIONARY 345 (2000).

<sup>167</sup> See I.R.C. § 11(a) (2018).

<sup>168</sup> DANIEL N. SHAVIRO, DECODING THE U.S. CORPORATE TAX 12-13 (2009).

(via lowering their return or paying less in dividends).<sup>169</sup> Because the ability to transfer the burden turns on market conditions, the law of supply and demand (including elasticity), contractual arrangements, and other factors, economic incidence is difficult to measure. Essentially the one who pays the tax may not be the one who suffers because of it.

## 2. Tribal Taxation

As sovereign governments, tribes have the power to impose taxes on their members and on nonmembers doing business within their jurisdiction.<sup>170</sup> Because of poor economic conditions on many reservations, tribes often use transaction-based taxes, like severance taxes, sales taxes, hotel occupancy taxes, and fuel taxes.<sup>171</sup> The hope is that the economic incidence of such taxes will fall on nonmembers doing business in Indian country.<sup>172</sup>

## 3. State Taxation in Indian Country

Recall that the federal government has exclusive authority over Indian tribes. State power in Indian country is, thus, rather limited. The U.S. Supreme Court has noted that states are prohibited from taxing tribes and tribal members directly with regard to their on-reservation activities unless such taxation has been allowed by federal law.<sup>173</sup> States may, however, generally tax tribal members and tribes on their off-reservation activities.<sup>174</sup> Absent federal

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<sup>169</sup> See *id.* at 70. After years of study, it is still difficult to pinpoint the bearer(s) of the corporate tax burden. See *id.* at 57-71.

<sup>170</sup> E.g., *Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130 (1982) (holding a tribe may impose, based on its inherent sovereign governmental powers, a severance tax on nonmember lessees extracting oil and gas from the reservation); *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134 (1980) (upholding a tribal cigarette tax on nonmembers purchasing cigarettes on the reservation).

<sup>171</sup> The Navajo Nation, for example, has one of the most sophisticated tribal tax systems, imposing, among others, a business activities tax, a per gallon fuel tax, a hotel occupancy tax, a sales tax, a severance tax, a liquor tax, a tobacco tax, and a “junk food tax.” See generally OFF. OF THE NAVAJO TAX COMM’N, <https://www.tax.navajonnsn.gov/>.

<sup>172</sup> See *id.*

<sup>173</sup> E.g., *Okla. Tax Comm’n v. Chickasaw Nation*, 515 U.S. 450, 453 (1995) (striking down a state fuel excise tax assessed on fuel sold by tribally owned stores and stating that a state tax will not stand if the legal incidence is directly on the tribe or a tribal member operating entirely on the reservation); *Montana v. Blackfeet Tribe of Indians*, 471 U.S. 759 (1985) (striking down a state tax on royalties the Blackfeet tribe received from nonmember lessees of oil and gas properties on the reservation); *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134 (1980) (striking down a state motor vehicle “privilege” tax assessed on tribal members); *Bryan v. Itasca County*, 426 U.S. 373 (1976) (striking down a state personal property tax on a mobile home owned by a tribal member because it was not explicitly authorized by federal law); *Moe v. Confederated Salish and Kootenai Tribes of the Flathead Reservation*, 425 U.S. 463 (1976) (striking down state cigarette and motor vehicle taxes where the legal incidence of the tax fell on a tribal member); *McClanahan v. State Tax Comm’n of Ariz.*, 411 U.S. 164, 165 (1973) (ruling that Arizona may not impose its personal income tax on a tribal member working exclusively on the reservation).

<sup>174</sup> See, e.g., *Okla. Tax Comm’n v. Chickasaw Nation*, 515 U.S. 450, 462-64 (1995) (upholding a state income tax on tribal members who worked for an Indian tribe, but who lived off of the reservation); *Mescalero Apache Tribe v. Jones*, 411 U.S. 145 (1973) (allowing the state of New Mexico to impose a gross receipts tax on a tribal ski resort operated outside of the tribe’s reservation).

preemption, a state is allowed to impose nondiscriminatory taxes on nonmembers doing business on Indian reservations located within the state's borders.<sup>175</sup>

The ability of states to impose taxes in Indian country turns on the legal incidence of the tax. If the legal incidence is on the tribe or tribal members, taxation is prohibited.<sup>176</sup> If the legal incidence is on a nonmember, taxation is generally allowed—even if the *economic* incidence of the tax is borne by the tribe or tribal members. Using legal incidence as the touchstone of taxation is formalistic. Although a state cannot impose the legal incidence of a tax on tribes or tribal members, it can effectively place the economic burden of the tax on the tribe or tribal members. States can easily control the legal incidence of their taxes by the wording of their statutes. States, for example, can place the legal incidence of a tax somewhere else in the supply chain—on non-member customers or vendors of the tribe.<sup>177</sup> If these nonmembers can pass the economic incidence of the tax on to the tribes or tribal members, then states are in effect taxing tribes and tribal members by calibrating their tax statutes to place the legal incidence of a tax on nonmembers.<sup>178</sup>

It should now be evident that states and tribes often have the ability *to tax the same transactions involving nonmembers doing business in Indian country*. For example, a state may impose its sales tax (with a legal incidence on customers) on tribal sales to nonmembers in Indian country at the same time the tribe imposes its own tax on those sales. This potential for double taxation can create contentious disputes between tribes and states.<sup>179</sup>

#### IV. INDIAN GAMING

“You know, if they’d just left us alone, we would have had a 25-table card room. But no, they had to push the issue, push the issue, and now there is Indian gaming all over the nation.”<sup>180</sup>

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<sup>175</sup> *E.g.*, *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134, 156-59 (1980) (upholding a state cigarette tax on nonmembers—even where the tribe imposed its own tax on such sales); *Moe v. Confederated Salish and Kootenai Tribes of the Flathead Reservation*, 425 U.S. 463, 483 (1976) (also upholding a state cigarette tax on nonmembers purchasing cigarettes on the reservation because the legal incidence of the tax fell upon the nonmember purchasers).

<sup>176</sup> See *supra* note 173.

<sup>177</sup> Mark J. Cowan, *Anatomy of a State/Tribal Tax Dispute: Legal Formalism, Shifting Incidence, Potatoes, and the Idaho Motor Fuel Tax*, 8 J. LEGAL TAX RESEARCH 15 (2010) [hereinafter Cowan, *Anatomy*] (discussing how Idaho, in the wake of a dispute with tribes in the state over fuel taxes, amended its statute in 2007 to move the legal incidence of the fuel tax to a nonmember/non-tribal party in the fuel supply chain).

<sup>178</sup> See *Okla. 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”).

<sup>179</sup> See, *e.g.*, *Washington v. Confederated Tribes of Colville Indian Reservation*, 447 U.S. 134, 156-59 (1980) (upholding a state cigarette tax on nonmembers—even where the tribe imposed its own tax on such sales); Cowan, *Anatomy*, *supra* note 177 (discussing a contentious fuel tax dispute between Idaho and tribes within in the state—where the state and each tribe wanted to impose a tax on fuel sold to nonmembers on Indian reservations). See also *infra* Part V.C.1.

<sup>180</sup> *The Native American Casino Boom in the US*, BBC NEWS WORLD SERVICE: WITNESS HISTORY (Feb. 6, 2020), <https://www.bbc.co.uk/sounds/play/w3csyx0z> [hereinafter BBC] (quoting Brenda Soulliere, former president of the Cabazon Band of Mission Indians).

In the 1980s, Indian gaming became a major source of state-tribal contention. With gaming, tribes took the lead—seeking to offer a service that was not available in other parts of the state. With cannabis, states took the lead, and certain tribes now want to join in offering the service. How the states, tribes, and federal government addressed Indian gaming is instructive in analyzing the tax landscape concerning cannabis sales on Indian reservations.

Indian gaming began in on a reservation in California in the early 1980s. The Cabazon Band of Mission Indians opened a bingo parlor and a poker room, which attracted off-reservation patrons—and the attention of the Riverside County Sheriff.<sup>181</sup> After its card room was raided by the Sheriff's Office,<sup>182</sup> the tribe went to court. In *California v. Cabazon Band of Mission Indians*,<sup>183</sup> the U.S. Supreme Court held that California could not prohibit or regulate gaming occurring on Indian reservations.<sup>184</sup> While the federal government had granted some states—including California—broad criminal jurisdiction in Indian country,<sup>185</sup> it had not granted the states regulatory jurisdiction.<sup>186</sup> Because California did not prohibit all gaming activities (for example, gambling was allowed at certain charitable events, and the state itself operated a lottery), the Court determined California *regulated* gaming rather than *prohibited* it.<sup>187</sup> In seeking to regulate gambling in Indian country, California was attempting to exercise its civil/regulatory jurisdiction, and thus was exceeding its authority.<sup>188</sup>

In response to *Cabazon*, Congress enacted the Indian Gaming Regulatory Act of 1988 (IGRA).<sup>189</sup> The IGRA gives states, tribes, and the federal government roles in regulating Indian gaming, and it allows tribes to operate casino-type games that are far more lucrative than the card room at issue in *Cabazon*. The IGRA divides Indian gaming into three classes. Class I includes traditional or ceremonial tribal games.<sup>190</sup> Class II includes bingo and certain card games.<sup>191</sup> All other games, including most casino games like blackjack, craps, and slot machines, fall into Class III.<sup>192</sup>

Class III games are the most lucrative and the ones the states most desire to prohibit or regulate. Class III games are thus heavily regulated—requiring the state to agree to such games

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<sup>181</sup> *Id.*

<sup>182</sup> *Id.*

<sup>183</sup> 480 U.S. 202 (1987).

<sup>184</sup> *Id.* at 222.

<sup>185</sup> In 1953, Congress enacted Public Law 83-280 (commonly known as “Public Law 280”) which (as later amended) granted six states, including California, substantial criminal jurisdiction on Indian reservations with within their borders (with some exceptions). *See* 18 U.S.C. § 1162 (2018).

<sup>186</sup> *See Cabazon*, 480 U.S. at 207.

<sup>187</sup> *Id.* at 211.

<sup>188</sup> *See id.* at 222.

<sup>189</sup> Codified at 25 U.S.C. §§ 2701-2721 (2018).

<sup>190</sup> 25 U.S.C. § 2703(6) (2018).

<sup>191</sup> 25 U.S.C. § 2703(7) (2018).

<sup>192</sup> 25 U.S.C. § 2703(8) (2018).

via a tribal-state compact that is approved by the Secretary of the Interior.<sup>193</sup> The IGRA's compact process has facilitated the proliferation of tribal casinos, and Indian gaming is now an industry with \$30 billion in annual revenue.<sup>194</sup>

The IGRA allows tribes to use profits from Class II and Class III games to fund government operations or programs, the general welfare of the Indian tribe and its members, the promotion of economic development, donations to charity, or the operations of local government agencies.<sup>195</sup> If a tribe adopts a plan to spend the profits on these activities, and the plan is approved by the Secretary of the Interior, then the tribe may distribute any excess income to members on a per-capita basis.<sup>196</sup>

Recall that tribes do not pay taxes on businesses they operate directly or through a tribal corporation.<sup>197</sup> Thus, if properly set up, tribes will not pay federal income tax on their casino profits. But the IGRA makes clear that per-capita distributions of the profits to tribal members are taxable to the recipients,<sup>198</sup> are subject to federal income tax withholding,<sup>199</sup> and the tribe is required to notify its members that distributions are taxable.<sup>200</sup>

If the casino is owned by the tribe and located on the reservation, its profits will not be subject to state income tax,<sup>201</sup> and a state cannot condition its acceptance of a gaming compact on the tribe agreeing to be subject to state tax.<sup>202</sup> A state can, however, negotiate for the tribe to impose its tribal taxes on transactions that are comparable to state taxes on similar transactions taking place off the reservation.<sup>203</sup> This result would ensure parity for on- and off-reservation taxation of nonmembers.

## V. TAX POLICY PROBLEMS AND PRESCRIPTIONS

If the cannabis industry is to grow, it must exist in a fair and clear tax system. This Part identifies current problems and recommends changes. Section A reviews the key tax policy principles evoked by the taxation of cannabis in Indian country. Section B explains how current or proposed laws could violate these principles at the federal level and offers prescriptions to

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<sup>193</sup> 25 U.S.C. § 2710(d)(1) (2018). The IGRA requires states to negotiate gaming compacts with tribes in good faith. 25 U.S.C. § 2710(d)(3) (2018). Class III games, however, cannot be conducted on Indian reservations located in states that prohibit all gaming for all purposes. 25 U.S.C. § 2710(d)(1)(B).

<sup>194</sup> BBC, *supra* note 180.

<sup>195</sup> 25 U.S.C. § 2710(b)(2)(B) (2018); 25 U.S.C. 2710(d)(1)(A)(ii) (2018).

<sup>196</sup> 25 U.S.C. § 2710(b)(3) (2018).

<sup>197</sup> See *supra* Part III.B.

<sup>198</sup> 25 U.S.C. § 2710(b)(3)(D) (2018).

<sup>199</sup> I.R.C. § 3402(r) (2018).

<sup>200</sup> 25 U.S.C. § 2710(b)(3)(D) (2018).

<sup>201</sup> See *supra* Part III.C.

<sup>202</sup> See 25 U.S.C. § 2710(d)(7)(B)(iii)(II) (2018) (directing courts to “consider any demand by the State for direct taxation of the Indian tribe or of any Indian lands as evidence that the State has not negotiated in good faith”).

<sup>203</sup> 25 U.S.C. § 2710(d)(3)(C)(iv) (2018).

remedy the violations. Section C mirrors this analysis at the sub-federal level. Section D provides a brief summary.

### A. Key Tax Policy Principles

Two fundamental tax policy principles, dating to Adam Smith's *The Wealth of Nations*, are evoked by the taxation of cannabis on the reservation: horizontal equity and certainty.

#### 1. Horizontal Equity

"It is generally agreed that taxes should bear similarly upon all people in similar real circumstances—especially those taxes, like the income tax whose central purpose is to approximate that result . . . ." <sup>204</sup>

"Perhaps the most widely accepted principle of equity in taxation is that people in equal positions should be treated equally. This principle of equality, or horizontal equity, is fundamental . . . ." <sup>205</sup>

Taxpayers will not consider a tax "fair" unless it achieves horizontal equity. That is, the tax should apply equally to taxpayers in similar situations. <sup>206</sup> With an income tax, for example, those with the same income should pay the same tax.

Most experts agree that horizontal equity is critical to a fair tax system. <sup>207</sup> For instance, the need to restore horizontal equity to the tax system drove Congress to enact the Tax Reform Act of 1986 <sup>208</sup> and shut down tax shelters that were artificially reducing taxes. <sup>209</sup> Taxpayers had been losing respect for the tax system, as it allowed them to rationalize cheating and buy their own tax shelters. <sup>210</sup> When horizontal equity is absent, taxpayers will perceive a tax system as

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<sup>204</sup> HENRY C. SIMONS, FEDERAL TAX REFORM 8 (1950).

<sup>205</sup> RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE 160 (1959).

<sup>206</sup> Joseph J. Cordes, *Horizontal Equity*, in THE ENCYCLOPEDIA OF TAXATION AND TAX POLICY 183-84 (Joseph J. Cordes et al. eds., 2d ed. 2005). Horizontal equity can be inferred from the concept of general equality/vertical equity/ability to pay, as articulated by Adam Smith in his maxims on taxation. ADAM SMITH, THE WEALTH OF NATIONS 1043 (5th ed. Edwin Cannan Editor, 2003) (1776). The idea of horizontal equity is similar to the principle applied in the justice system, that "[l]ike cases should be decided alike." See BRYAN A. GARNER, ET AL., THE LAW OF JUDICIAL PRECEDENT 21 (2016). Without it, respect for the law would erode.

<sup>207</sup> Richard A. Musgrave, *Horizontal Equity, Once More*, 43 NAT'L TAX J. 113, 113-23 (1990). But see Louis Kaplow, *Horizontal Equity: Measures in Search of a Principle*, 42 NAT'L TAX J. 139, 139-55 (1989) (arguing that horizontal equity is merely a subset of the ability to pay principle/vertical equity—the notion that those with more income should pay more in taxes).

<sup>208</sup> Pub. L. No. 99-514, 100 Stat. 2085.

<sup>209</sup> Cordes, *supra* note 206, at 184.

<sup>210</sup> Long-time House Ways and Means Committee Chair Wilbur Mills called the tax system a "house of horrors" because of special tax breaks and asked, "Can you believe that two more or less average American men could earn the same amount of actual income, live side by side in identical houses on an identical standard of living—but that one of them must pay five times as much federal income tax as the other?" Wilbur D. Mills, *Are You a Pet or Patsy?*, LIFE, Nov. 23, 1959 at 51.



unfair, be less likely to respect the tax system, and more likely to rationalize gaming the system. An effective tax system cannot generate adequate revenues in such an environment.<sup>211</sup>

Horizontal equity is not relevant when a tax is meant to limit externalities, such as excise taxes on tobacco or cannabis.<sup>212</sup> It is thus acceptable to tax cannabis more heavily than other products without violating horizontal equity. However, horizontal equity demands that cannabis businesses be taxed the same.

## 2. Certainty

“The tax which each individual is bound to pay ought to be certain, and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person . . . .”<sup>213</sup>

Taxing statutes must be clear about who is taxed and in what amount. When uncertainty extends to whether a tax applies at all, however, the consequences are graver. If there is ambiguity over who is taxed and who is exempt, multiple statutes at play, or multiple bodies of law (like Indian law, tax law, and constitutional law) at issue, taxpayers will claim exemptions, and costly litigation would result.<sup>214</sup> A tax simply cannot be fair, effective, and raise adequate revenue if clouded by uncertainty.

## B. Federal

### 1. Current Federal Tax Policy Problems

Horizontal equity problems with current federal taxation of the cannabis business in Indian country are clear. If a tribe owns a cannabis business,<sup>215</sup> Section 280E does not apply because the Internal Revenue Code does not apply. Consider the following example, which applies Section 280E and denies deductions (other than cost of goods sold) to the privately-owned cannabis retailer:

	<b>Non-Cannabis Retailer</b>	<b>Privately-Owned Cannabis Retailer</b>	<b>Tribal Cannabis Retailer</b>
Gross Sales	10,000,000	10,000,000	10,000,000
Cost of Goods Sold	(7,000,000)	(7,000,000)	(7,000,000)
Gross Margin	3,000,000	3,000,000	3,000,000
Rent	(300,000)	(300,000)	(300,000)

<sup>211</sup> Of course, “inequities” are sometimes “more apparent than real.” Cordes, *supra* note 206, at 184. It is therefore important to measure horizontal equity based on the often elusive economic incidence rather than the easier to identify legal incidence. See *supra* Part III.C.1.

<sup>212</sup> Cordes, *supra* note 206, at 184.

<sup>213</sup> SMITH, *supra* note 206, at 1043-44.

<sup>214</sup> See, e.g., the many examples of disputes over a relatively simple provision of the tax law, Section 280E, at *supra* Part II.A.3.

<sup>215</sup> If a tribal member owns a cannabis business, it will be taxed like any other cannabis business, and thus will not result in a violation of horizontal equity.

Utilities	(100,000)	(100,000)	(100,000)
Advertising	(200,000)	(200,000)	(200,000)
Salaries	(1,000,000)	(1,000,000)	(1,000,000)
“Actual” Income	1,400,000	1,400,000	1,400,000
Taxable Income	1,400,000	3,000,000	0
Tax at Corporate Tax Rate of 21% <sup>216</sup>	294,000	630,000	0
After-Tax Income (“Actual” Income less Tax)	1,106,000	770,000	1,400,000

The tax difference between the non-cannabis and the privately-owned cannabis retailers could be justified by the externalities that can result from cannabis use.<sup>217</sup> The real horizontal equity problem is between privately-owned cannabis businesses and tribally-owned cannabis businesses. Here, tribes enjoy a significant tax preference that gives them an unfair competitive advantage in the cannabis industry. Tribal cannabis operations also enjoy another advantage: they do not have to bifurcate their operations between cannabis and non-cannabis to partially escape Section 280E. In contrast, non-tribal cannabis dispensaries have expended considerable, often futile, effort to show they are operating some non-cannabis businesses.<sup>218</sup>

## 2. Potential Federal Tax Policy Developments

In addition to addressing existing federal tax policy concerns, we must look to possible federal legalization of cannabis. Congress could take a variety of approaches,<sup>219</sup> but two recent proposals are instructive: the Marijuana Revenue and Regulation Act (MRRA)<sup>220</sup> and the Marijuana Opportunity Reinvestment and Expungement Act of 2019 (MORE).<sup>221</sup> In general, each bill would legalize cannabis at the federal level and create a federal regulatory regime. Each bill would also remove cannabis from the CSA’s schedules,<sup>222</sup> which would render Section 280E ineffective for cannabis businesses.<sup>223</sup>

<sup>216</sup> The rate can vary depending on how the business is structured. See *supra* Part II.A.4.

<sup>217</sup> See *supra* note 212 and accompanying text. Section 280E’s legislative history states that Congress intended to treat traffickers in controlled substances more harshly than other businesses. See *supra* note 62 and accompanying text.

<sup>218</sup> See *supra* Part II.A.3.

<sup>219</sup> See, e.g. JANE G. GRAVELLE & SEAN LOWRY, CONG. RESEARCH SERV., R43785, FEDERAL PROPOSALS TO TAX MARIJUANA: AN ECONOMIC ANALYSIS (2014) (discussing various ways of taxing cannabis—including by price, weight, or potency).

<sup>220</sup> S. 420, 116th Cong. (2019) (introduced by Sen. Wyden, perhaps being a bit too on the nose with the numbering).

<sup>221</sup> H.R. 3884, 116th Cong. (2019). The bill would also amend all of federal law to replace the term “marihuana” or “marijuana” with “cannabis.” *Id.* at § 10. Another legalization bill, the Strengthening the Tenth Amendment Through Entrusting States Act (STATES Act) contains no tax provisions. S. 1028, 116th Cong. (2019).

<sup>222</sup> S. 420, 116th Cong. § 201 (2019); H.R. 3884, 116th Cong. § 2 (2019).

<sup>223</sup> See I.R.C. § 280E (2018) (disallowing deductions only for business trafficking in Schedule I and Schedule II controlled substances).

Although cannabis businesses would be relieved of Section 280E, they would also be subject to a new price-based federal excise tax on cannabis.<sup>224</sup> The tax would be the liability of the cannabis “manufacturer,” defined as any person who plants, cultivates, harvests, produces, manufactures, compounds, processes, prepares, or packages a cannabis product, and would be due at removal from inventory.<sup>225</sup> Removal occurs when the product is moved or sold to the next link in the supply chain—traditionally the wholesaler. For vertically integrated “seed to sale” operators, a “constructive price” would be calculated.<sup>226</sup> MRRA would create a new excise tax for cannabis at an initial rate of 10%, which would rise over five years to 25%.<sup>227</sup> It does not appear to exempt medical cannabis. MORE would consolidate the tax on cannabis with the existing tax on tobacco and impose a tax of 5%,<sup>228</sup> which would not apply to medical cannabis.<sup>229</sup>

### 3. Federal Tax Policy Prescriptions

**Federal Income Tax.** Tribes currently enjoy a tremendous federal income tax advantage over non-tribal cannabis businesses. This horizontal equity problem would be reduced if Congress de-schedules cannabis, thus removing Section 280E from the legal cannabis industry. Even if Congress neutralizes Section 280E, a horizontal equity problem would remain, because tribes still do not pay federal income tax.

To achieve horizontal equity, should tribes be taxed on their cannabis profits? The answer depends on how we view tribes. Tribes are governments that frequently operate businesses. If you view the tribe as a government, its cannabis profits should not be taxed. State governments do not pay federal income taxes, even when earning commercial income via gaming (lotteries), convention centers, or liquor stores. Tribes, as governments, should not either. If you view the tribe as a business,<sup>230</sup> however, it should be taxed on its business profits. Private cannabis businesses pay federal income tax. Thus, tribal cannabis stores should as well.

Because of a tribe’s multiple roles, horizontal equity problems are not completely soluble, but the example set by the IGRA could help.<sup>231</sup> The IGRA did not attempt to tax tribes on their casino income; it let tribes develop a plan to spend their profits on government expenses and then distribute any excess profits to tribal members on a per-capita basis. The IGRA expressly made these per-capita payments taxable. In doing so, it effectively struck a balance

<sup>224</sup> See, e.g., Carl Davis, *Cannabis Legalization: Tax Cut or Tax Hike?*, 165 TAX NOTES FEDERAL 449, 455 (Oct. 21, 2019) (concluding that Section 280E’s disallowance of deductions to cannabis businesses “might have an impact roughly equivalent to a 6.25 percent tax on the sales price of cannabis”).

<sup>225</sup> S. 420, 116th Cong. § 101 (Sec. 5902(9)) (2019); H.R. 3884, 116th Cong. § 4(b) (2019).

<sup>226</sup> The constructive price subject to tax would be the lower of the price the cannabis is sold at retail or the highest price for which manufacturers ordinarily sell the product to wholesalers, as determined by the government. See I.R.C. § 4216(b) (2018) (MORE, referencing the existing constructive price rules in the tobacco rules); S. 420, 116th Cong. § 101 (Sec. 5903(c)(2)) (2019) (MRRA).

<sup>227</sup> S. 420, 116th Cong. § 101 (Sec. 5901(b)) (2019).

<sup>228</sup> H.R. 3884, 116th Cong. § 4(b) (2019).

<sup>229</sup> *Id.*

<sup>230</sup> I am not suggesting tribes are businesses; they are governments. But, like states, tribes own and operate businesses, and thus we must view tribes as businesses for purposes of determining the appropriate tax treatment.

<sup>231</sup> See *supra* Part IV.

between the tribe as a government (where profits are not taxable if used for government operations or benefits) and the tribe as a business owner (where profits not used for government operations or benefits are taxed at the member level). The IGRA thus respected the tribe's dual role.

Congress, as part of its cannabis reform efforts, should consider an IGRA-type of law for cannabis sales in Indian country. It could be called the Indian Cannabis Regulatory Act (ICRA). Under this hypothetical ICRA, a tribe entering the cannabis business would need to develop a plan to use the cannabis profits for government operations or for payments to tribal members that would qualify under the GWE. Excess profits could be distributed on a per-capita basis to members, and would expressly be subject to taxation and withholding. If the cannabis business thrives, only profits not spent on governmental operations would be taxed. If the cannabis business does not thrive, then none of its income would be taxed because there would not be any excess profits to distribute to tribal members. An ICRA would be the federal government's best shot at maintaining horizontal equity over cannabis sales in Indian country—without disturbing the tribes' long-standing exemption from federal income taxation.

In enacting an ICRA, Congress should also be concerned with the tax policy issue of certainty. Because an ICRA would be layered on top of the IGRA and the GWE, it must be clear about which tribal government payments to members would be exempt under the GWE and which tribal government payments to members would be taxable under the IGRA or ICRA. As noted earlier, lack of certainty in this easily-clarified area has led to litigation.<sup>232</sup>

**Excise Taxes.** It is not clear whether the proposed federal excise tax on cannabis would apply to cannabis sales by Indian tribes. As noted earlier, tribes are subject to some excise taxes but are exempt from others.<sup>233</sup> In the interest of certainty, whether the tribes are subject to or exempt from the federal cannabis excise tax should be made explicit. Leaving the position ambiguous for tribes would only lead to litigation.<sup>234</sup>

Beyond the issue of certainty is, once again, the issue of horizontal equity. Some have suggested that tribes should be exempt from any federal excise tax on cannabis, perhaps as long as 50 years, to allow tribes to develop the industry.<sup>235</sup> Such a tax holiday would create serious horizontal equity problems. If Congress wants to exempt tribes from federal cannabis taxes to encourage economic development, it should state so clearly and be willing to live with the market distortions that result.

The decision whether to tax the tribes should turn on the expected structure of the industry upon federal legalization. If the cannabis industry continues to be operated by private enterprises, tribes should be subject to the excise tax to ensure horizontal equity. If federal legalization fosters state-run cannabis businesses, then either the states and tribes should both be subject to the tax or neither should be. A tax exemption would provide a substantial and visible tax advantage to tribal or perhaps state cannabis stores. This result raises the issue of tax salience,<sup>236</sup> “the extent to which taxpayers account for the costs imposed by taxation when the

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<sup>232</sup> See *supra* notes 148-151 and accompanying text.

<sup>233</sup> See *supra* Part III.B.2.

<sup>234</sup> See *supra* notes 161-164 and accompanying text.

<sup>235</sup> Smith, *supra* note 29, at 549-50.

<sup>236</sup> There is a vast literature on salience in taxation. For discussion of the leading works, see David Gamage & Darien Shanske, *Three Essays on Tax Salience: Market Salience and Political Salience*, 65 TAX L. REV. 19 (2011).

taxpayers make decisions or judgments.”<sup>237</sup> Because they are imposed at the producer rather than retail level, excise taxes generally are hidden in the price and do not have as much salience as sales taxes.<sup>238</sup>

While excise taxes in general are low in salience, cannabis taxes might not be. If cannabis is not subject to federal excise tax on the reservation but is subject to it off reservation, customers will notice. Tribes could charge a lower price and distort the market, and, if the federal government imposes an MRRRA-like tax at 25%, the difference will be quite salient.<sup>239</sup>

Unlike with the federal income tax, tribes have historically not enjoyed a blanket exemption from federal excise taxes. That fact, and the horizontal issues at stake, favor subjecting tribes to any new federal cannabis excise tax (assuming states are treated the same way).

### C. *States and Tribes*

#### 1. Sub-Federal Tax Policy Problems

It is hard to apply horizontal equity principles at the sub-federal level because there are multiple governments involved and no coordination mechanism among them.<sup>240</sup> More general issues of fairness arise when a product is taxed differently on versus off the reservation. The unique sub-federal tax landscape that applies in Indian country<sup>241</sup> can create both unfair advantages and disadvantages for tribes.

First, looking at the unfair advantages, recall that states’ ability to impose taxes on Indian reservations turns on the legal incidence of the tax. Although legal incidence is easier to determine than economic incidence, the legal incidence is not always clear.<sup>242</sup> If the state (perhaps inadvertently) places the legal incidence on a tribe or tribal member, the tax will be ineffective, and it would allow the tribe to capture the revenue from the tax by either imposing its own tax or marketing a tax exemption to nonmembers. For example, on-reservation cannabis stores might sell products at a lower price than nearby off-reservation stores because of the tax advantage.

Sometimes, a state tax validly applies on the reservation, but the state is limited in its ability to enforce collection. This dynamic arose in many states with cigarette taxes. Tribes and tribal members would use their exemption from state taxes to improperly sell cigarettes to

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<sup>237</sup> *Id.* at 23.

<sup>238</sup> See *id.* at 23, n. 11 (quoting economist Milton Friedman for this proposition with respect to the value added tax).

<sup>239</sup> See Oglesby, *Look Out*, *supra* note 92, at 543 (noting that people will travel outside of their city of residence to get lower-taxed cannabis in nearby cities).

<sup>240</sup> For an exploration of these vexing issues, see MUSGRAVE, *supra* note 205, at 179-83 (discussing how, theoretically, horizontal equity might be achieved on the total tax bill across multiple taxing jurisdictions).

<sup>241</sup> See *supra* Part III.C.

<sup>242</sup> See generally Cowan, *Anatomy*, *supra* note 177, at 1 (discussing cases where a court disagreed with a state over whether the legal incidence of a state tax fell on a tribe or tribal member).

nonmembers free of state tax locally or over the Internet.<sup>243</sup> Tribal-state disputes over cigarette taxes have even become tumultuous.<sup>244</sup>

So far, there is no indication that tribes are entering the cannabis business to market a tax exemption. Rather, they are entering the industry to run cannabis businesses (often seed to sale) for the profit potential.<sup>245</sup> But the situation could change unless tribes, states, and the federal government work together to ensure a fair tax structure.

Let's look at the unfair disadvantages at the sub-federal level for tribes. As noted earlier, states and tribes often have the ability to tax the same transactions. A tribe may impose a sales tax, for example, on on-reservation sales. A state may impose its own sales tax on on-reservation sales, provided the legal incidence is placed on the nonmember customer and not the tribal retailer. This overlapping state/tribal taxing jurisdiction may result in double taxation. The possibility of double taxation can have a chilling effect on nonmember investment in Indian country that stifles economic development. For example, a nonmember company extracting oil on an Indian reservation may be subject to both state and tribal severance taxes.<sup>246</sup> If that same company had been operating outside of Indian country, only the state tax would apply. All else being equal, the nonmember company would most likely choose to operate on non-Indian land before exploiting the resources within Indian country. One economic analysis noted, for example, that a double severance tax would reduce on-reservation production, leading not only to a reduction in tax revenue, but a reduction in royalties paid to the tribe and a reduction in on-reservation employment opportunities.<sup>247</sup>

The potential economic impact of a double tax on cannabis has not been explored. A double tax, however, would obviously put on-reservation cannabis stores at a competitive disadvantage compared to nearby off-reservation cannabis stores. Furthermore, the specter of double taxation would discourage both tribes and nonmembers from opening cannabis stores on Indian reservations.<sup>248</sup> For the cannabis industry to function in Indian country, this specter must be removed. Fortunately, there are no indications that states and tribes are battling over cannabis taxes or are imposing simultaneous taxes, but that could change as the industry spreads and the tax revenue at stake rises.

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<sup>243</sup> See, e.g., *Red Earth LLC v. United States*, 657 F.3d 138 (2d Cir. 2013) (reviewing constitutional challenges to the Prevent All Cigarette Trafficking Act of 2009). Cigarette taxation involves different issues from cannabis and federal legislation in this area complicates things.

<sup>244</sup> See Dean Schabner, *Indians Cigarette Tax Fight Smolders*, ABC NEWS (Jan. 7, 2006) <https://abcnews.go.com/US/story?id=96774&page=1>. Further discussion of implementation/enforcement/collection issues is beyond the scope of this article. If the governments involved work together to create a fair and clear multijurisdictional tax system to govern cannabis sales, there will be less likelihood of contentious, cigarette-tax-like disputes over compliance.

<sup>245</sup> See *supra* Part I.B.

<sup>246</sup> See e.g., *Cotton Petroleum Corp. v. New Mexico*, 490 U.S. 163 (1989) (upholding both state and tribal severance taxes on the production of oil and gas on reservation land by nonmembers).

<sup>247</sup> Robert William Alexander, *The Collision of Tribal Natural Resource Development and State Taxation: An Economic Analysis*, 27 N.M. L. REV. 387, 416 (1997).

<sup>248</sup> But see Richard D. Pomp, *The Unfulfilled Promise of the Indian Commerce Clause and State Taxation*, 63 TAX LAW. 897, 1220 (2010) (questioning “whether double taxation should be viewed as even existing when a tribe is simultaneously the taxing sovereign and the vendor of the taxed good” because in that case the label “tax” is just a formality with “no independent economic significance”).

One could argue about which government (state or tribal) is at fault for the presence of double taxation. In reality, both tribes and states need to finance their operations and both provide services (such as roads, schools, a court system) that benefit nonmembers operating in Indian country. Accordingly, in most cases, both the tribe and the state have valid claims to tax revenue from activity taking place on Indian reservations. Implicitly acknowledging this reality, the Supreme Court has largely refused to prioritize one government's assertion of tax jurisdiction over the other's; often allowing both the state tax and tribal tax to stand. The absence of a jurisprudential resolution to the competing (and often meritorious) tribal and state claims to taxation stokes historic enmity between tribes and states and can lead to rather contentious tax disputes. There have been drawn-out, acrimonious disputes, for example, over whether the tribe or the state has priority to impose fuel taxes.<sup>249</sup>

## 2. Sub-Federal Tax Policy Prescriptions

The cannabis industry in Indian country is still at an early stage. Knowing the cost of prior tax disputes, it would behoove states and tribes to avoid repeating the same tax battles they have fought in the past. Absent a revision in the Supreme Court's views on state/tribal tax matters, there are two primary ways that state/tribal tax conflicts could effectively be resolved: congressional intervention or the use of state/tribal compacts. Congress could use its plenary power over the tribes and its power over state taxes that implicate interstate commerce to develop a scheme that reconciles tribal and state claims to taxation of nonmembers in Indian country. However, even if Congress wished to deal with this issue, it is unlikely that Congress would be able to develop one set of rules that would fairly reconcile competing state and tribal claims to tax revenue in every case. Each state/tribe relationship is unique—with the state providing some services and the tribe providing others. In addition, cannabis taxes and regulations vary greatly by state. Given the diversity of state/tribal relations, a national “one size fits all” rule is unlikely to yield satisfactory results in all cases.

As an alternative to Congressional action, states and tribes can try to put aside their differences and negotiate tax compacts to avoid double taxation, provide certainty, and allocate tax revenue between the two governments. To wit, over 200 state/tribal tax compacts are in existence.<sup>250</sup> The provisions of tax compacts can vary greatly.<sup>251</sup> Often, however, the tribe will agree to collect a tax on the reservation that equals the state tax charged off the reservation. This agreement prevents the reservation from becoming a tax haven and also eliminates the specter of double taxation. The state and the tribe then agree how they will divide the revenue collected via the on-reservation tax. Idaho, for example, resolved a multi-year dispute with several tribes over fuel taxes via a negotiated compact.<sup>252</sup>

Compacts are advantageous to both parties and to the business community because the compacts provide certainty in an otherwise confusing area of the law. With a compact, the state and the tribe are assured of a predictable revenue stream, and the business community is assured that it will not be treated more harshly on the reservation than off it.

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<sup>249</sup> See Cowan, *Anatomy*, *supra* note 177 (discussing a contentious state-tribal tax dispute over fuel taxes in Idaho).

<sup>250</sup> COHEN'S HANDBOOK, *supra* note 3, at § 8.05.

<sup>251</sup> For some examples, see *id.* at § 8.05.

<sup>252</sup> See Cowan, *Anatomy*, *supra* note 177.

It can be difficult, however, to get states and tribes to put aside their differences, but the IGRA can provide a framework. The IGRA required the tribes and states to negotiate a compact before a tribe could operate Class III gaming on its reservation.<sup>253</sup> A similar compact could be required for cannabis under an ICRA.<sup>254</sup> A model compact might be provided, which would address regulatory and tax issues. This approach would allow the federal government to assist in reconciling tribal-state interests while not imposing a one-size fits all rule.

Even if no ICRA is forthcoming, states and tribes can resolve any local problems among themselves. In fact, there are models already in place. Washington was the pioneering state, passing legislation empowering its governor to negotiate cannabis contracts with Indian tribes located in the state and setting standard terms for such compacts.<sup>255</sup> In 2015, Washington entered into the nation's first compact state-tribal cannabis compact—with the Squamish Tribe.<sup>256</sup> Under the compact, sales of cannabis on the reservation are not subject to state taxation,<sup>257</sup> but the tribe must impose a tax equal to at least 100% of the state tax on sales of cannabis on the reservation.<sup>258</sup> Exceptions are provided 1) for sales of cannabis to the tribe, its affiliates, members of the tribe or their businesses, 2) if the product was grown, produced, or processed on the reservation, 3) for transactions otherwise exempt under federal or state law, and 4) for sales of medical cannabis.<sup>259</sup> The tribe may tax such sales if it so chooses.<sup>260</sup> If the state requests, the tribe must hire an auditor to verify compliance.<sup>261</sup> Any tax proceeds must be used by the tribe for essential government services.<sup>262</sup>

Following Washington's example, Nevada passed legislation in 2017 enabling the governor to enter into cannabis compacts with Indian tribes.<sup>263</sup> Nevada now has compacts in

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<sup>253</sup> 25 U.S.C. § 2710(d)(1) (2018).

<sup>254</sup> Tribes and states might want to support an ICRA for non-tax reasons as well. Some tribes may want to legalize cannabis but the states within which they are located do not. Or some states may want to legalize but a tribe in the state does not. An ICRA framework would help resolve these issues, as the IGRA did for gaming.

<sup>255</sup> WASH. REV. CODE § 43.06.490 (2019).

<sup>256</sup> Marijuana Compact Between the Squamish Tribe and the State of Washington (Sept. 15, 2015), <https://lcb.wa.gov/publications/Marijuana/Compact-9-14-15.pdf> [hereinafter Squamish Compact]. Washington and other tribes have subsequently entered into similar compacts. *E.g.*, Marijuana Compact Between the State of Washington and the Puyallup Tribe of Indians (2015), <https://assets.documentcloud.org/documents/2699297/Puyallup-Tribal-Compact.pdf>.

<sup>257</sup> Squamish Compact, *supra* note 256, at § V.F.1.

<sup>258</sup> *Id.* at § V.F.2.

<sup>259</sup> *Id.*

<sup>260</sup> *Id.*

<sup>261</sup> *Id.* at § V.F.2.b.

<sup>262</sup> *Id.* at § V.F.2.a. Essential government services include, for example, “administration, public facilities, fire, police, health, education, elder care, social services, sewer, water, environmental and land use, transportation, utility services, community development, and economic development.” *Id.* at § IV.D.

<sup>263</sup> NEV. REV. STAT. § 223.250 (2019). The legislative history of this statute reports that Nevada wanted to enact a similar system to Washington's “successful system for cooperation with the tribal governments in its state.” 2017 Statutes of Nevada, Ch. 305, SB 375, at 1617.



place with several tribes located in the state.<sup>264</sup> Although the tax provisions of the Nevada compacts mostly mirror the Washington ones, there is one important difference. Nevada, unlike Washington, did not agree to exempt reservation-grown cannabis from the requirement that the tribe tax cannabis at a rate of at least 100% of the state tax rate.<sup>265</sup> This difference is further evidence that a national approach to tax issues in Indian country is not advisable. Local differences and preferences should be accommodated.

Compacts are not perfect. Both the state and the tribe must cede some sovereignty when entering into a compact. In particular, tribes give up some control over how cannabis will be taxed. In Washington and Nevada, the tribes agreed to impose (at least) the same taxes as the state. Thus, the tribes must follow the lead of the state as it tweaks its tax system. As tax issues in the nascent cannabis industry must be properly calibrated,<sup>266</sup> what is ideal for the state as a whole may not work well in Indian country. Perhaps that result is a small price to pay to ensure fairness and certainty.

#### D. Summary

At the federal level, tribes are quietly benefiting from their tax-exempt status, which includes their exemption from Section 280E. This benefit yields an unfair advantage to be sure, but one that tribes did not choose. Section 280E is the product of Congress, and only Congress can fix the resulting inequities. If tribes wish to be active in the cannabis industry, they should want the industry as a whole to succeed, and that success is more likely to happen if the industry operates in a federal tax system that strives for horizontal equity. From a business strategy standpoint, therefore, tribes should not resist an ICRA-type law that imposes an income tax on per-capita distributions to tribal members. Nor should tribes try to get a special exemption from any forthcoming federal excise tax on cannabis. If tribes want to be part of the industry, they should be treated the same as other cannabis businesses.

At the sub-federal level, it appears that tribes and states have been focusing on turning cannabis into a viable industry, not on exploiting tax advantages provided by a complex, often unfair system. So far, a spirit of cooperation seems to be the norm, but the temptation to exploit long-standing inequities in the tax system is not far away. Tribes and states should resist this temptation and keep the focus where it belongs—on providing a safe and sustainable cannabis industry.

Tribes must partner with their adjacent states to ensure an even playing field for taxes both on and off the reservation. This partnership will allow the tribe to compete and raise revenue without any special tax advantage or disadvantage. That result will be good for the industry as a whole, but it only solves part of the problem. The federal government, the only sovereign with the power to remove the Section 280E problem and create a national framework for both states and tribes, must act. When it does, perhaps via an ICRA, it must keep the important tax policy goals of horizontal equity and certainty clearly in focus. In the meantime,

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<sup>264</sup> E.g., Marijuana Compact Between the Las Vegas Tribe of Paiute Indians and the State of Nevada (July 18, 2017), [http://marijuana.nv.gov/uploadedFiles/marijuanannvgov/Content/Stay\\_Informed/Ely-Shoshone-Compact-Fully-Executed.pdf](http://marijuana.nv.gov/uploadedFiles/marijuanannvgov/Content/Stay_Informed/Ely-Shoshone-Compact-Fully-Executed.pdf) [hereinafter Paiute Compact]. A full list of Nevada's cannabis compacts with tribes is available at *Stay Informed*, MARIJUANA IN NEVADA, [http://marijuana.nv.gov/Stay\\_Informed/Resources/](http://marijuana.nv.gov/Stay_Informed/Resources/) (last visited Mar. 10, 2020).

<sup>265</sup> See Paiute Compact, *supra* note 264, at § V.E.2. (not listing an exemption for reservation-grown cannabis).

<sup>266</sup> See *supra* Part II.B.

tribes and states must continue to resolve matters locally. In doing so, they would be well-advised to look to the state-tribal compacts in Nevada and Washington as examples.

## CONCLUSION

The current law surrounding the cannabis industry is uncertain. Tax is just one part of this complicated puzzle. Until the federal government acts, the states, the tribes, and the industry must bear the burden of these complexities with as much grace as possible. Since we are at an early stage, now is an opportune time for the three sovereigns to coordinate their efforts and level the tax playing field between on and off reservation sellers. States or tribes should not try to exploit an often ambiguous, unfair, and multi-sovereign tax structure to their advantage. Instead, they should work with their fellow sovereigns to develop a fair and certain tax framework that will allow the cannabis industry to grow. The best strategy for the cannabis industry, including the tribal cannabis industry, is to support these efforts. It is the industry's stability and growth, fostered by a clear and fair tax system, which—through increased economic development and additional tax revenue—will benefit all the governments involved over the long term. Tax disparities—like cannabis itself—might temporarily alleviate some symptoms, but they won't cure the underlying ailments.