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Gov Agency: General Fund Taxes—Other General Fund Taxes—Cigarette Tax Refund Percentage

Recommendations:

Paper No. 121 Alternative 2

Comments: The governor wants to reduce the percentage of cigarette tax collections that would be refunded to Indian tribes on sales to non-tribal members from 70% to 50%. According to the governor, the cigarette tax revenue sharing process was developed as a means to promote Native American economic development. The governor argues that since gaming has become a major source of revenue for the tribes, the cigarette tax revenue sharing agreement is overly generous. (See point 9)

Doesn't sound like a bad idea necessarily, but it seems premature. The administration has not really discussed this idea in depth with the tribes, and until they do, it doesn't seem like a good approach to just go forth with the plan. (See points 17 and 18.) Alt. 2 directs the DOR to enter into negotiations with the tribes regarding the cigarette tax refunds. It makes no change to current law regarding the amounts refunded for this biennium.

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Cigarette Tax Refund Percentage (General Fund Taxes -- Other General Fund Taxes)

[LFB 1999-01 Budget Summary: Page 44, #1]

CURRENT LAW

As set forth in the Constitution of the United States, treaties, statutes and court decisions, Congress may limit the authority of Indian tribes, but within those limits an Indian tribe is a legitimate governmental entity possessing attributes of sovereignty over its members and territory. State taxation of tribal members on reservations is prohibited where the subject matter is pre-empted by federal law or where the tax would infringe on the right of Indians living on reservations to self-government. Under federal law, states are prohibited from imposing a cigarette tax on sales of cigarettes by Native Americans to Native Americans on reservations. However, a state may assess a cigarette tax on sales that occur on tribal lands to non-Native American purchasers and may require the Native American seller to collect the tax for the state on such sales.

Wisconsin statutes direct the Department of Revenue (DOR) to refund 70% of cigarette taxes from all sales on reservations or trust lands of an Indian tribe that were designated as such on or before January 1, 1983. The statutes further authorize DOR to enter into agreements with the tribes to provide for the refunding of 100% of cigarette tax collections from sales on reservations to tribal members. The net effect of these provisions is a 70% refund on sales to non-tribal members and a 100% refund on sales to tribal members.

Ten of the 11 Indian tribes in the state have signed agreements in which the tribes agree to sell only stamped (taxed) cigarettes and the state agrees to provide refunds to the tribes of 100% of cigarette taxes paid on sales to tribal members. The agreements specify that the tribal council will be reimbursed for 70% of taxes paid on all of its cigarette purchases (or purchases by a person authorized to sell cigarettes by the council on the reservation) and specify the process for estimating and paying the remaining 30% of taxes for sales to tribal members. The agreement is in effect until terminated in writing by either party upon thirty days notice to the other party.

The tribe that does not have an agreement with the state sells unstamped (untaxed) cigarettes to tribal members and stamped cigarettes to non-tribal members. For this tribe, the only taxes collected are from the sale of stamped cigarettes to non-tribal members. The state refunds 70% of such taxes and retains the remaining 30%.

Cigarette tax refunds to Native American tribes are paid through a sum sufficient GPR appropriation.

GOVERNOR

Reduce, from 70% to 50%, the percentage of cigarette tax collections that would be refunded to Indian tribes on sales to non-tribal members and reduce funding for such refunds by $2,500,000 in 1999-00 and $3,000,000 in 2000-01.

This provision would first apply to taxes imposed on the first day of the second month beginning after publication of the bill.

DISCUSSION POINTS

1. The administration has estimated that the change in the refund rate would lead to reductions in refunds to Native American tribes of $2,500,000 in 1999-00 and $3,000,000 in 2000-01. The estimates for the first year assume an effective date of September 1, 1999. However, the bill would also provide that these provisions take effect on the first day of the second month beginning after publication of the bill. Assuming that the bill would be published in August, 1999, the effective date of the provisions would be October 1, 1999.

The estimates are also based on the administration's projections of refunds under current law of $10,400,000 in 1999-00 and $10,900,000 in 2000-01. However, based on a revised estimate of refunds under current law to $9,520,000 in 1999-00 and $9,320,000 in 2000-01 (see Issue Paper #120) and adjusting to the October 1, 1999, effective date, it is now estimated that the proposed decrease in the refund rate would lead to reductions in refunds of $1,836,000 in 1999-00 and $2,397,000 in 2000-01. These estimates, which are lower than the administration's figures by $664,000 in the first year and $603,000 in the second year, assume that the tribes that are currently selling only stamped cigarettes would continue to do so. As described below, if this were not the case, the state could expect to see reductions in both tax collections and refunds from cigarette sales on reservations.

2. The refund rate is specified in agreements with the tribes as well as in the statutes. Therefore, if the statutory refund rate were changed, the agreements would have to be renegotiated. If the tribes did not agree to the new rate, it is possible that they would choose not to enter into new

agreements and would stop selling stamped cigarettes to tribal members.

The absence of agreements would have no net impact on the general fund as long as the tribes continued to sell stamped cigarettes to non-tribal members and the state continued to provide refunds on these sales based on the statutory rate. Enforcement of the sale of stamped cigarettes to non-tribal members could prove to be more difficult, however, as it did prior to the current refund arrangement (see discussion below). If the tribes were to sell unstamped cigarettes to non-tribal members, net general fund revenues could decrease.

3. The current refund process was negotiated in the early 1980s, partially as a means of resolving the problem of black market cigarettes being sold on reservations that developed following a decision of the U.S. Supreme Court. Prior to late 1978, Native American retailers sold stamped cigarettes. A 1978 Supreme Court decision barring the state of Montana from imposing its cigarette tax on Native American sellers was interpreted to apply to Wisconsin. This determination was made because, at that time, Wisconsin's cigarette tax was imposed as an occupational tax (a tax on sellers for the privilege of engaging in a particular business). As a result of the court decision, Native American retailers began selling unstamped (untaxed) cigarettes beginning in December, 1978, and sales on reservations grew from approximately 2.6 million packs in 1979-80 to 19.2 million packs in 1982-83. It was estimated that most of these sales were to non-tribal members.

4. Under state law, non-Native American consumers were liable for the amount of tax due through a parallel use tax on cigarettes. However, it was difficult for the Department of Revenue to enforce the use tax. Enforcement agents would stop individuals leaving Native American retail shops, determine whether the individual was a tribal member and search the individual for unstamped cigarettes. Penalties were assessed if needed and cigarettes could be confiscated. This approach was costly when compared to the amount of revenue collected. In addition, the Department's enforcement efforts were unpopular with customers of the Native American retailers. Native American retailers also found it difficult to determine who was eligible to purchase untaxed cigarettes and objected to filing reports indicating the volume of taxable and exempt sales. Finally, non-Native American retailers were concerned that they were being unfairly competed against.

5. To remedy the enforcement problem, address the concerns of non-Native American retailers and to lessen the paperwork burden on Native American sellers, the tax on cigarettes was converted from an occupational tax to an excise tax (a tax on the consumer) as part of the 1983-85 biennial budget (1983 Wisconsin Act 27) and the current reimbursement provisions were established. The Department of Revenue subsequently negotiated agreements with ten of the 11 tribes to sell only taxed cigarettes (as described under current law, the tribe without an agreement currently sells unstamped cigarettes to tribal members and stamped cigarettes to non-tribal members). In exchange, the state agreed to provide refunds to the tribes of 100% of taxes paid on sales to Native Americans and 70% of taxes paid on sales to non-Native Americans.

6. A number of Wisconsin's neighboring states have also made agreements regarding the taxation of cigarettes sold by Native American retailers. The state of Illinois does not have any

Native American tribes within its borders. It should be noted that, although none of the neighboring states have delineated the specifics of their agreements in statute, other states, such as Wisconsin, have.

a. *Iowa.* There are two small tribes in the state of Iowa. The Native American retailers sell stamped cigarettes and can apply for a refund for the tax paid on cigarettes sold to tribal members. When applying for a refund, the retailers submit cash register receipts and information on the number of packs sold to tribal members. They are audited periodically for compliance. No refund is provided for cigarettes sold to non-tribal members. This refund procedure was arrived at by negotiation with the tribes and it not specified in the Iowa statutes.

b. *Michigan.* There are 11 Native American tribes in the state of Michigan. Until recently, the state had agreements with seven of the tribes under which the tribes purchased tax-free cigarettes from certain designated distributors and collected tax on sales to non-tribal members. These agreements have expired, and the state is currently negotiating new agreements with all of the tribes. In the meantime, the seven tribes that had such agreements are operating under the expired agreements. Distributors notify the Michigan Department of Treasury monthly of the number of cigarette packs sold to Native American retailers. The tribal retailers are required to collect the tax on all cigarettes sold to non-tribal members and are audited each year to determine the amount of tax due. Although the tribal retailers are audited for compliance, the Treasury Department is not confident that all of the tax owed is being collected. The state would prefer to negotiate agreements in which taxes would be collected at the wholesale level and the tribes would apply for refunds based on estimated per capita sales.

Agreements with the tribes are not specified in the Michigan statutes. One tribe has a separate agreement with the state under which the tribe buys taxed cigarettes and is refunded monthly for sales to tribal members based on a study of cigarette consumption by its tribal members. There are no agreements with the other three tribes since they are very small and do not have any tribal-owned retail shops.

Minnesota. Minnesota statutes provide the Commissioner of Revenue with broad authority to enter into agreements to share taxes with tribes. The statutes do not specify the refund rate or other details of these agreements. The statutes explicitly state that tribes may purchase unstamped cigarettes from wholesalers in amounts that would meet the personal consumption needs of tribal members. However, as described below, none of the 11 tribes in Minnesota are purchasing untaxed cigarettes for tribal consumption.

The state recently entered into new agreements with ten of the 11 tribes located in Minnesota that cover sales, cigarette, tobacco, liquor and gasoline taxes. These agreements provide that the tribes sell taxed products to tribal members as well as non-tribal members. The state, in turn, agrees to refund the tribes for 100% of taxes collected on sales of cigarettes (as well as the other products) to tribal members based on per capita estimated consumption, and 50% of taxes from sales to non-tribal members. In 1992, the Revenue Department sent letters to the tribes indicating that the state wanted to renegotiate the prior agreements, which were based on a 70% refund rate. A new agreement was negotiated with each of the ten tribes at the 50% refund rate. The first new agreement was signed in 1995. The tribe that does not have an agreement buys taxed cigarettes from distributors and does not apply for refunds from the state.

7. Cigarette tax rates have increased from 25¢ per pack when the agreements were first negotiated to the current rate of 59¢ per pack. The administration has pointed out that the original tribal share of 17.5¢ (70% of 25¢), adjusted for inflation, would be 29¢ per pack today, which would be comparable to the proposed 50% refund rate (the 50% refund would be 29.5¢ per pack based on the current tax rate of 59¢).

8. The administration has also stated that its overall goal in modifying the cigarette tax refund provision was to ensure that tribal revenues were held constant following the 15¢ increase in cigarette taxes from 44¢ to 59¢ in November, 1997. Cigarette tax refunds averaged $8,151,000 for 1995-96 and 1996-97, the two fiscal years prior to the 15¢ increase. It is estimated that current law refunds would be $9,520,000 in 1999-00 and $9,320,000 in 2000-01. This paper estimates that, with the lower refund percentage in the bill, cigarette tax refunds would be $7,684,000 in 1999-00 and $6,923,000 in 2000-01. Based on these estimates, refunds at the 50% rate would be less than the average refund in the two years prior to the 15¢ tax increase by $467,000 in 1999-00 and $1,228,000 in 2000-01.

9. According to the administration, when the cigarette tax revenue sharing process was developed in Wisconsin it was viewed as a means of promoting Native American economic development in addition to being a practical way to resolve the problem of black market cigarettes being sold on reservations. With the recent rise of Native American gaming, the economic status of the tribes has been changing. In light of changes in the tax rate and improved economic conditions of some of the tribes, the revenue sharing arrangement may be viewed by some, including competing non-Native American retailers, as unnecessarily generous.

10. It could be argued that all of the taxes collected from sales of cigarettes to non-tribal members should be retained by the state. It has been suggested that one way to do so would be to collect taxes on cigarettes using a procedure similar to that used to collect taxes on motor vehicle fuel sold on reservations.

Like the cigarette tax, the tax on motor vehicle fuel is an excise tax that is generally collected at the wholesale level but is to be paid by the ultimate consumer. Native Americans are not subject to taxes on the fuel they purchase if the fuel is delivered to them on their tribal reservation, except where any of the fuel is purchased for resale to both Native Americans and to non-Native Americans. In such cases, the motor vehicle fuel tax is pre-collected, meaning that reservation retailers purchase fuel at prices that include the motor vehicle fuel tax. When making a nontaxable sale to a tribal member, the reservation retailer is required to obtain an exemption certificate from the buyer. The retailer may then sell the fuel at a retail price that excludes fuel taxes and claim a refund from DOR of taxes it paid on nontaxable sales to Native Americans.

Because of limitations imposed by federal law, states are prohibited from requiring pre-collection of taxes on all cigarettes sold to tribes or their approved tribal retailers as is done for motor vehicle fuel taxes. Pre-collection of taxes would mean that the tribes could only buy stamped cigarettes. However, a state could pass legislation to require that a quota be established on the quantity of unstamped cigarettes that wholesalers may sell to tribes and tribal retailers. The purpose of a quota system would be to limit sales of unstamped cigarettes to the tribes, thereby minimizing the likelihood that unstamped cigarettes would be sold to non-tribal members. The right of a state to establish such a quota was upheld by the U.S. Supreme Court in a 1994 decision, Department of Taxation and Finance of New York, et al., v. Milhelm Attea & Bros., Inc., et al. (Milhelm Attea), as described below.

11. The Department of Taxation and Finance of the State of New York adopted administrative rules limiting the quantity of untaxed cigarettes that wholesalers could sell to tribes and tribal retailers out of concern that cigarette taxes were not being collected on sales to non-tribal members. Before being implemented, the cigarette wholesalers filed suit to enjoin enforcement of the regulations (Milhelm Attea). In June, 1994, the U.S. Supreme Court held that the quota system and reporting requirements were justified by New York's legitimate interest in preventing the illegal sale of tax-exempt cigarettes and that they did not unduly interfere with Native American trading.

By early May of 1997, New York had reached agreements with six Native American tribes for implementation of the regulations. However, on May 22, 1997, the Governor of New York directed the Department of Taxation and Finance to repeal the regulations due to violence that resulted. Subsequently, a bill was introduced to modify New York law to allow reservation retailers to sell tax-free cigarettes. Although New York clearly has the legal right to require the Native American retailers to collect and remit the cigarette tax on sales to non-tribal members, other extenuating factors have prevented these regulations from being enforced.

12. New York is again engaged in litigation regarding cigarette taxes, this time in a case brought by the New York Association of Convenience Stores to protest the lack of enforcement of cigarette taxes on sales on reservations to non-tribal members. The initial case commenced in August, 1995, and has not yet been resolved. According to the New York Department of Taxation and Finance, there are also a number of bills in the New York Legislature addressing taxation of cigarettes sold by the tribes, but there is no consensus on a long-term solution.

13. Legally, Wisconsin could implement a quota system and reporting requirements similar to the regulatory scheme adopted by the state of New York that was upheld by Milhelm Attea. However, it is possible that Wisconsin would experience problems with implementation similar to those experienced in New York. If such problems led to the abandonment of a quota system, as they did in New York, and there was not a system of partial refunds to tribes for taxes on cigarette sales to non-tribal members, it is likely that the tribes would sell unstamped cigarettes and the enforcement challenges experienced prior to the enactment of the refund provision would reoccur. It is also possible that lack of effective enforcement would result in litigation such as the State of New York has been in for nearly five years.

14. If the state eliminated the partial refunds of taxes collected on cigarette sales on

reservations to non-tribal members, the tribes would experience a significant loss in revenue, as long as they continued to sell taxed cigarettes to non-tribal members. However, if the tribes were to sell unstamped cigarettes to non-tribal members, the state could experience a loss in general fund revenues.

15. In 1997-98, the 70% refund of taxes on sales to non-tribal members was an estimated $8,570,000. According to DOR, the tribes continue to rely on the refunds to fund their governmental services. Tribal representatives indicate that some tribes depend on the refunds to finance health care, day care, housing and family programs.

16. An additional issue to that of the economic impact on tribal budgets of a change in the refund rate is the process under which a change in the rate would be made. A number of tribes have objected to the Governor's proposal for what they perceive to be a unilateral action on the part of the state with respect to a previously negotiated arrangement. One tribe has referred to the Governor's proposal to change the statutory rate without consulting the tribes as an act of bad faith and disrespect. Members of the Legislature's American Indian Study Committee have also objected to the lack of consultation with the tribes; the Chairperson of the Committee has requested that the treatment of cigarette and tobacco products taxes be removed from the budget for consideration as separate legislation so that the state and the tribes could consult on the proposals.

17. The administration discussed reducing the refund rate with representatives of the Oneida Nation prior to submitting the budget bill. However, while the administration believes that the Oneida Nation agreed to the reduced refund rate, representatives for the tribe have stated that the tribe agreed only to discuss such a reduction at a future time. After September 1, 1998, DOR began to adjust the cigarette tax refund claim forms submitted by the Oneida Nation to reflect a refund rate of 50% of taxes collected. The tribe voided and returned the refund checks, requesting refunds at the 70% rate specified in the statutes and in the written agreement between the Oneida Nation and the state.

Since that time there has been a series of correspondence between the Oneida Nation and DOR. The tribe repeatedly returned refund checks it received that were based on a 50% refund rate. The Department subsequently stopped sending refund checks and has instead deposited refunds into an escrow account. Such deposits are based on the 70% refund rate. According to an attorney for the Oneida Nation, the tribe is currently investigating options with respect to litigation on this issue. The tribe is also considering additional options, such as ending its agreement with the state to sell only taxed cigarettes.

18. In order to avoid additional conflicts with the tribes over the refund rate and the process used to change the rate, it may be desirable to approach a modification of the refund provision by renegotiating agreements with tribes before reducing the statutory percentage. In this way, if a new agreement could be reached, a reduction in the statutory rate could be proposed without the tribes perceiving that the state was unilaterally changing the terms of what had previously been considered to be a negotiated agreement.

19. The success of such a process would require the state and each tribe to agree in separate negotiations to the same rate. The change would subsequently have to be approved by the Legislature. The process would be lengthy and there would be no guarantee that all parties involved would agree on a single rate.

20. Another option would be to adopt a modified version of the system used by the State of Minnesota. Under such a system, the statutes could be changed to specify the 70% refund rate as the maximum allowable rate. DOR could be required to refund a percentage of the taxes, at a rate less than or equal to the maximum 70%, that would be determined in agreements between the state and the individual tribes. A representative for the state, such as the Secretary of DOA or the Secretary of DOR, could be authorized to enter into agreements that would specify the refund rate for taxes on sales to non-tribal members. In order to comply with federal law, the statutes would continue to specify that such agreements would provide for the refunding of 100% of cigarette taxes imposed on sales to tribal members.

ALTERNATIVES

No 1. Approve the Governor's recommendation to reduce, from 70% to 50%, the percentage of cigarette tax collections from sales of cigarettes on reservations or trust lands that would be refunded to Indian tribes. However, modify the estimated reduction in refunds under the proposal to $1,836,000 in 1999-00 and $2,397,000 in 2000-01. The revised estimates are $664,000 smaller in 1999-00 and $603,000 smaller in 2000-01 than the administration's estimates.

Alternative 1	GPR
1999-01 FUNDING (Change to Bill)	$1,267,000

#1 2. Delete the Governor's recommendation. Instead, direct DOR to enter into negotiations with the tribes and pursue statutory changes subsequent to such negotiations. Under this alternative, estimated cigarette tax refunds for 1999-01 would be the same as the modified estimates under current law (which would be $2,500,000 greater in 1999-00 and $3,000,000 greater in 2000-01 than the estimates included in the bill).

Alternative 2	GPR
1999-01 FUNDING (Change to Bill)	$5,500,000

3. Delete the Governor's recommendation. Instead, specify a maximum refund rate of 70% and require DOR to refund a percentage of the taxes at a rate determined in individual agreements with the tribes. In addition, authorize a state official to enter into agreements that would specify the refund rate (at or below the 70% maximum) for taxes on sales to non-tribal members. The statutes would continue to specify that such agreements would provide for the refunding of 100% of cigarette taxes imposed on sales to tribal members. Specify that the state official authorized

to negotiate such agreements with the tribes would be:

a. The Secretary of DOA; or

2nd b. The Secretary of DOR.

Alternative 3 (either "a" or "b")	GPR
1999-01 FUNDING (Change to Bill)	$5,500,000

OK 4. Maintain current law.

Alternative 4	GPR
1999-01 FUNDING (Change to Bill)	$5,500,000

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