STATE OF ARIZONA

OFFICE OF THE ATTORNEY GENERAL

ATTORNEY GENERAL OPINION by TERRY GODDARD ATTORNEY GENERAL December 22, 2006	No. I06-007 (R06-033) Re: The Application of Proposition 201, Smoke-Free Arizona Act, to Taxation of On-Reservation Tobacco Sales

To: Gale Garriott
Director, Arizona Department of Revenue

Questions Presented

You have requested a formal opinion answering the following questions concerning the application of Proposition 201, more commonly known as the "Smoke-Free Arizona Act," passed by the electorate at the general election held November 7, 2006:

Will the Tobacco Tax for Smoke-Free Arizona levied under new section A.R.S. § 42-3251.02 apply to on-reservation sales of tobacco products? If so:

1) Would the tax apply only to purchasers other than enrolled members of the tribe and under circumstances in which such sales are not otherwise exempt from the current Indian Reservation Tax under A.R.S. § 42-3304?

2) Would the tax be levied as a direct tax on the consumer that is precollected and remitted by the distributor, as the current Indian Reservation Tobacco Tax is pursuant to A.R.S. § 42-3303, or would it be levied under a different theory of taxation?

3) Would the tax be offset by a luxury/excise tax imposed by the tribe that is equal to or greater than the tax?

Summary Answer

The tobacco tax implemented and levied under the Smoke-Free Arizona Act and new section A.R.S. § 42-3251.02 does not apply to on-reservation sales of tobacco products by tribes or tribal members[1] to non-tribal members. The tax does apply to on-reservation sales of tobacco products by federally licensed Indian traders or other non-tribal members to non-tribal members. Because Proposition 201 does not incorporate the provisions of Title 42, Chapter 3, Article 7 (A.R.S. §§ 42-3301 to 42-3306), neither the "direct tax on consumers" provision nor the luxury/excise tax setoff applies to the new tax.

Background

Arizona voters approved Proposition 201 in the 2006 general election. The measure establishes the following: (1) a ban on smoking in all public places and places of employment within the State of Arizona with some enumerated exceptions; (2) the imposition of an additional tax of one-tenth of one cent on each cigarette sold; and (3) the Smoke-Free Arizona Fund for the deposit of all revenues collected from the additional tax and to be used to enforce the smoking ban. Ariz. Sec'y of State, *Ballot Propositions*

[1] For purposes of this Opinion, the term "tribal member" denotes an enrolled member of the tribe for the benefit of which the reservation on which the transaction in question takes place was established. Thus, a "non-tribal member" would include someone who is a member of a tribe established on a reservation other than the one on which the transaction at issue takes place, as well as someone who is not a member of any tribe.

and Judicial Performance Review for the Gen. Election of Nov. 7, 2006 ("Publicity Pamphlet") at 87-90. Any money remaining in the Smoke-Free Arizona Fund after the Department of Health Services meets its enforcement obligations are to be deposited in the Tobacco Products Fund and to be used for education programs to reduce and eliminate tobacco use. Publicity Pamphlet at 90.

Section 4 of Proposition 201 establishes the smoking ban and the Smoke-Free Arizona fund through the addition of new statute A.R.S. § 36-601.01. Subsection N of A.R.S. § 36-601.01 states that "[t]his section [A.R.S. § 36-601.01] has no application on Indian reservations as defined in A.R.S. § 42-3301(2)."

Section 5 of the Proposition 201 establishes the additional cigarette tax through the addition of new statute A.R.S. § 42-3251.02:

> A.R.S. § 42-3251.02. Levy and Collection of Tobacco Tax for Smoke-Free Arizona Fund.
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> A. In addition to the taxes imposed by 42-3251(1), there is levied and shall be collected an additional tax of one tenth of one cent on each cigarette.
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> B. Monies collected pursuant to this section shall be deposited, pursuant to §§ 35-146 and 35-147, in the Smoke-Free Arizona Fund established by § 36-601.01.

Your question concerns the application of these new statutes to on-reservation sales of tobacco.

Analysis

State taxation of tobacco sales on Indian reservations has a long and circuitous history in the courts. Ultimately, courts have applied a flexible approach under which state tax laws apply to on-reservation transactions involving non-members of an Indian tribe unless authority to do so would be preempted by federal law or would interfere or is

incompatible with federal and tribal interests reflected in federal law. *New Mexico v. Mescalero Apache Tribe*, 462 U.S. 324, 334 (1983); *State ex rel. Ariz. Dep't of Revenue v. Dillon*, 170 Ariz. 560, 566, 826 P.2d 1186, 1192 (App. 1991).

Prior to 1994, there was no specific methodology in the Arizona statutes to tax on-reservation sales of tobacco. At that time, the only excise tax on tobacco in Arizona was a luxury privilege tax on tobacco. *See* A.R.S. § 42-3052. This tax, which is still in effect, is an excise tax on the privilege of selling certain luxury items to consumers.[2] *Watkins Cigarette Serv., Inc. v. Ariz. State Tax Comm'n*, 111 Ariz. 169, 171, 526 P.2d 708, 710 (1974). The vendor is responsible for paying the tax, for it is the vendor who is paying for the privilege of engaging in selling luxury items. *Id.* at 172, 526 P.2d at 711; Ariz. Att'y Gen. Op. I79-141.

In 1994, Proposition 200 was approved by the electorate, adding two new articles to Chapter 3 of Title 42.[3] Article 6 imposes the Tobacco Tax for Health Care (currently set forth in A.R.S. §§ 42-3251 to 42-3253), and Article 7 imposes the Indian Reservation Tobacco Tax (currently set forth in A.R.S. §§ 42-3301 to 42-3306). Article 6 sets forth a new tax on several different types of tobacco (*see* A.R.S. § 42-3251) and directs that

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[2] The luxury privilege tax set forth in A.R.S. § 42-3052 applies to on-reservation tobacco sales by federally licensed Indian traders to non-tribal members. *See Dillon*, 170 Ariz. at 570, 826 P.2d at 1196. However, this tax does not apply to on-reservation sales from the tribe or tribal members to other tribal members. This is because state law is generally inapplicable when on-reservation conduct involving only tribal members is at issue. *See White Mountain Apache Tribe v. Bracker*, 448 U.S. 136, 144 (1980) (holding that state tax laws did not apply to business activity of non-Indian logging company conducted solely on reservation) (citing *Moe v. The Confederated Salish & Kootenai Tribes*, 425 U.S. 463, 480-481 (1976)). In addition, the luxury tax does not apply to sales from non-tribal members to tribal members. *See Dillon*, 170 Ariz. at 567, 826 P.2d at 1193 (state taxation of federally licensed Indian traders is preempted only to the extent of their receipts from reservation sales to reservation Indians). And, because the tax is a vendor tax, it does not apply to on-reservation sales from tribes or tribal members to non-tribal members.

[3] The two articles were initially added as Article 1.2 (codified as A.R.S. §§ 42-1241 & 42-1242) and Article 1.3 (codified as A.R.S. §§ 42-1251 to 42-1257) of Title 42–The Taxation Code. The Taxation Code was reorganized by Laws 1997, Chapter 150. The reorganization resulted in the renumbering of much of the Code. Consequently, the articles added in 1994 as articles 1.2 and 1.3 of Chapter 7 are now situated at articles 6 and 7 of Chapter 3 of the Code.

these monies be deposited into the tobacco tax and health care fund established by A.R.S. § 36-771. *See* A.R.S. § 42-3252. Article 7 applies this new tax to on-reservation tobacco sales pursuant to the particular rates set forth in A.R.S. § 42-3251, specifically incorporating that section by reference. *See* A.R.S. § 42-3302(A). Article 7 also provides that the revenue be deposited in the tobacco tax and health care fund established by A.R.S. § 36-771 and the tobacco products tax fund established by A.R.S. § 36-770. *See* A.R.S. § 42-3302(B).

In addition, Article 7 lays out a luxury/excise tax setoff option for the tribes. If a tribe imposes its own tax on tobacco at a rate that is less than the state tax, then the tax is levied at a rate equal to the difference between the state tax rate and the tribal tax rate. *See* A.R.S. § 42-3302(C)(1). If a tribe imposes its own tax on tobacco at a rate that is equal to or greater than the state tax, then the tax rate is zero. *See* A.R.S. § 42-3302(C)(2). Article 7 also provides that "[t]he taxes levied pursuant to this article are conclusively presumed to be direct taxes on the consumer but shall be precollected and remitted to the department by the distributor for purposes of convenience and facility only." A.R.S. § 42-3303(A). Finally, A.R.S. § 42-3304 exempts the tax levied when taxes have already been paid under the Tobacco Tax For Health Care and when tobacco is sold by an Indian tribe or by a federally licensed Indian trader on a reservation to tribal members. Thus, Proposition 200 in 1994 established that the new tobacco tax would be applied to on-reservation sales from tribes or tribal members to non-tribal members.[4]

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[4] The Arizona Department of Revenue issued a luxury tax ruling following the adoption of the Indian Reservation Tobacco Tax. This ruling required licensed Indian traders to sell cigarettes with the same type of blue stamp used for sales off the reservation, as contrasted with sales by tribal members to non-tribal members that required a red stamp. Arizona Luxury Tax Ruling 94-1. The statutory administration of tobacco sales requires that distributors affix tax stamps to packages of cigarettes. *See* A.R.S. §§ 42-3202 to 42-3210; Arizona Luxury Tax Ruling 94-1.

In 2002, the voters passed Proposition 303, which imposed another health care tobacco tax, embodied in new statute A.R.S. § 42-3251.01. Proposition 303 also amended the Indian Reservation Tobacco Tax in A.R.S. § 42-3302(A) to explicitly refer to newly added § 42-3251.01, as well as continuing to refer to § 42-3251.

In addition to adding new § 36-601.01 which establishes the ban on smoking and the Smoke-Free Arizona Fund, Proposition 201 also adds new statute § 42-3251.02, which is a new tobacco tax under Article 6, Tobacco Tax for Health Care; it joins the two taxes previously mentioned, passed in 1994 and 2002 and encoded at A.R.S. §§ 42-3251 and 42-3251.01. However, Proposition 201, unlike the propositions in 1994 and 2002, does not amend the Indian Reservation Tobacco Tax in Article 7. A.R.S. § 42-3302 continues to refer only to the previously enacted health care tobacco taxes in A.R.S. §§ 42-3251 and 42-3251.01. Article 7 cannot be applied to A.R.S. § 42-3251.02 without rewriting the language of the statutes therein. Consequently, the tax imposed by Proposition 201 does not apply to on-reservation sales through the operation of Article 7 and the Indian Reservation Tobacco Tax. The question becomes, can the new tax be otherwise imposed upon on-reservation sales from tribes or tribal members to non-tribal members?

Whether the state can tax on-reservation sales from tribes or tribal members to non-tribal members depends upon whom the legal incidence of the tax falls. In *California State Board of Equalization v. Chemehuevi Indian Tribe*, the United States Supreme Court held that California could indeed require tribes to collect taxes on cigarettes sold by the tribe to non-tribal members. 474 U.S. 9, 12 (1985). The Court arrived at this conclusion because, in reading the California cigarette tax scheme as a

whole, it was evident that the legal incidence of the tax fell on the consuming purchaser. *Id.* at 11-12.

Here, however, there is nothing in the Arizona tax scheme that would imply that the legal incidence of the tax imposed by new A.R.S. § 42-3251.02 is on the consumer. On the contrary, Proposition 201 failed to amend the Indian Reservation Tobacco Tax in Article 7 to reflect the inclusion of this new tax, or to apply the same presumptive conclusion that the legal incidence of the tax was on the consumer that Article 7 applies to A.R.S. §§ 42-3251 and 42-3251.01. *See* A.R.S. § 42-3303(A) ("The taxes levied pursuant to this article are conclusively presumed to be direct taxes on the consumer."). The Arizona Supreme Court has held that the words of a statute "will be read to gain their fair meaning, but not to gather new objects of taxation by strained construction or implication." *Ariz. State Tax Comm'n v. Staggs Realty Corp.*, 85 Ariz. 294, 297, 337 P.2d 281, 283 (1959). In interpreting revenue statutes, the courts liberally construe statutes imposing taxes in favor of taxpayers and against the government. *State ex rel. Ariz. Dep't of Revenue v. Capitol Castings, Inc.*, 207 Ariz. 445, 447, 88 P.3d 159, 162 (2004); *see also Energy Squared, Inc. v. Ariz. Dep't of Revenue*, 203 Ariz. 507, 510, 56 P.3d 686, 689 (App. 2002) ("Uncertainty about the scope and meaning of a taxing provision is to be resolved in favor of the taxpayer and against the taxing authority."). That the drafters of Proposition 201 could have applied a similar presumption but did not indicates that no such presumption was meant to apply. And, if the legal incidence of the tax does not fall on the non-tribal member consumer, it cannot be applied to on-reservation sales from tribes or tribal members to non-tribal members.

Regarding the application of the new tax to on-reservation sales from non-tribal sellers to non-tribal purchasers, this Office finds that the tax is applicable to such sales. In *State ex rel. Arizona Department of Revenue v. Dillon*, a federally licensed Indian trader argued that he was not liable for the taxes on cigarettes he sold to non-tribal members on the reservation because his business was federally regulated and states were therefore preempted by federal law from imposing a state tax on reservation purchases. 170 Ariz. at 566, 826 P.2d at 1192; *see also* 25 U.S.C. §§ 261-264 (federal statutes requiring non-tribal members engaging in trade with tribal members on the reservation to be federally licensed traders and governing business practices). The court held that federal law did not preempt the state from imposing the tax, because "[s]tate jurisdiction over activities on Indian reservations is preempted by federal law only if it interferes or is incompatible with federal and tribal interests reflected in federal law." *Id.*, at 566, 826 P.2d at 1192. Federal law regulates the practice of licensed Indian traders, but, the Court said, since Dillon's sale of cigarettes to non-tribal members was not part of his federally regulated Indian trading, there was no federal policy disturbed by Arizona's taxation of Dillon's cigarette sales to non-Indians. *See id.*

Finally, because Proposition 201 does not incorporate Article 7 of Title 42 to include the new tax, the provision in A.R.S. § 42-3303 stating that the taxes in Article 7 are direct taxes on the consumer, but are precollected and remitted to the Department is inapplicable. Likewise, regarding the luxury-excise tax setoff, the only provision for such a setoff is set forth in the Indian Reservation Tobacco Tax in Article 7. *See* A.R.S. § 42-3302(C). Given that Proposition 201 does not amend Article 7 to incorporate the new

tax set forth in A.R.S. § 42-3251.02, the luxury/excise tax setoff in Article 7 does not apply either.

Conclusion

The new tobacco tax established by Proposition 201 applies to on-reservation sales from non-tribal members to non-tribal members. The new tax does not apply to on-reservation tobacco sales from tribes or tribal members to non-tribal members. Because Proposition 201 does not amend the Indian Reservation Tobacco Tax in Article 7 to incorporate or reference new statute A.R.S. § 42-3251.02, the new tax is not subject to the luxury/excise tax setoff established by A.R.S. § 42-3302(C) or the provision in A.R.S. § 42-3303 providing that the tax is a direct tax on the consumer.

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