STATE OF ARIZONA

OFFICE OF THE ATTORNEY GENERAL

ATTORNEY GENERAL OPINION by TERRY GODDARD ATTORNEY GENERAL December 22, 2006	No. I06-008 (R06-034) Re: The Application of Proposition 203, the Arizona Early Childhood Development and Health Initiative, to Taxation of On-Reservation Tobacco Sales

TO: Gale Garriott
Director, Arizona Department or Revenue

Questions Presented

You have requested a formal opinion answering the following questions[1] concerning the application of the Proposition 203, more commonly known as the Arizona Early Childhood Development and Health Initiative, passed by the electorate at the general election held November 7, 2006:

Will the Tobacco Tax for Early Childhood Development and Health levied under new section A.R.S. § 42-3371 apply to sales of tobacco products on Indian reservations? 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?

[1] On December 1, 2006, this Office issued Ariz. Att'y Gen. Op. No. I06-006, which addressed your question relating to the amount of the tax increase on cigarettes imposed by Proposition 203. This Opinion addresses your remaining questions relating to Proposition 203.

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 Tax for Early Childhood Development and Health levied under new statute A.R.S. § 42-3371 does not apply to on-reservation sales of tobacco by tribes or tribal members[2] to non-tribal members. It does apply to on-reservation sales of tobacco by federally licensed Indian traders or other non-tribal members to non-tribal members. Because Proposition 203 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

At the 2006 general election, voters approved Proposition 203, which provides dedicated funding for early childhood development and health programs and establishes a statewide structure to coordinate these programs. It establishes an early childhood development health care board and fund along with regional partnership councils throughout the state to identify childhood development and health services needs at the local level and provides for distribution of monies and grants to eligible programs serving pre-kindergarten-age children.

[2] 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.

Indian tribes located in a designated region are represented in the partnership council by either one public official or an employee of the tribal government. A.R.S. § 8-1162(A)(9) (as added by Proposition 203). Indian tribes may either participate in designated regions, in which their land is located, or elect to be treated as a separate region. A.R.S. § 8-1164(D) (as added by Proposition 203).

Proposition 203 establishes a tax on tobacco products to fund these programs by amending Title 42, Chapter 3 of the Arizona Revised Statutes to add new Article 9 and statute A.R.S. § 42-3371, which provides:

> In addition to all other taxes, there is levied and shall be collected by the department in the manner provided by this chapter, on all cigarettes, cigars, smoking tobacco, plug tobacco, snuff and other forms of tobacco the following tax:
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> 1. On each cigarette, four cents.
>
> 2. On smoking tobacco, snuff, fine cut chewing tobacco, and refuse, scrubs, clippings, cuttings and sweepings of tobacco, excluding tobacco powder or tobacco products used exclusively for agricultural or horticultural purposes and unfit for human consumption, 9 cents per ounce or major fraction of an ounce.
>
> 3. On all cavendish, plug or twist tobacco, 2.2 cents per ounce or fractional part of an ounce.
>
> 4. On each twenty small cigars or fractional part weighing not more than three pounds per thousand, 17.8 cents.
>
> 5. On cigars of all descriptions except those included in paragraph 4, made of tobacco or any tobacco substitute:
>
> (A) If manufactured to retail at not more than five cents each, 8.8 cents on each three cigars.
>
> (B) If manufactured to retail at more than five cents each, 8.8 cents on each cigar.

A.R.S. § 42-3371 (as added by Proposition 203). The taxes collected under A.R.S. § 42-3371 are to be deposited in the early childhood development and education fund. A.R.S. § 42-3372 (as added by Proposition 203).

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.[3] *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

[3] 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. 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.

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.[4] 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 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 also 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

[4] 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.

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, the passage of 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.[5]

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.

Unlike the 1994 and 2002 propositions, Proposition 203 did *not* amend Article 7 to include a reference to the newly imposed tax in new statute A.R.S. § 42-3371, nor did it expressly incorporate any other provisions from Article 7, including the conclusive presumption that the legal incidence of the tax falls upon the consumer. A.R.S. § 42-3303(A). While Proposition 203 does include provisions specifically relating to the tribes' participation in early childhood health and development programs, *see* A.R.S. § 8-1162(A)(9) & § 8-1164(D), it contains no language indicating whether or how the new tax in A.R.S. § 42-3371 is meant to apply to on-reservation tobacco sales. The fact that the drafters of Proposition 203 could have amended Article 7 to incorporate the tax

[5] 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.

embodied in A.R.S. § 42-3371 along with the other health care taxes applied to on-reservation sales from tribes or tribal members to non-tribal members, as was done in 2002, but did not do so indicates that the new tax was not meant to apply to such sales.

Moreover, the Department has consistently applied the taxes set forth in the Indian Reservation Tobacco Tax in Article 7 of Title 42 to on-reservation tobacco sales from tribes or tribal members to non-tribal members. *See* Arizona Luxury Tax Ruling 94-1. The drafters of Proposition 203 and the electorate were presumably aware that the Department applied Article 7 as the vehicle for taxing such sales, yet did not incorporate the new tax into Article 7. *Cf. State ex rel. Ariz. Dep't of Revenue v. Short*, 192 Ariz. 322, 324-25, 965 P.2d 56, 58-59 (App. 1998) (noting that in construing statute legislature is presumed to know how administrative department interprets statutes it is responsible for administering).

A.R.S. § 42-3371 does state that the new tax "shall be collected by the Department in the manner provided by this chapter," but this general language does not incorporate the new tax into the Indian Reservation Tobacco Tax in Article 7. First, doing so would mean assuming that the drafters chose this general language as a means of incorporation instead of specifically incorporating the new tax by reference, as the drafters of the previous 1994 and 2002 propositions did. Given that these previous propositions affirmatively amended Article 7 to include the tobacco taxes in on-reservation transactions, this assumption is unlikely to be correct. Second, Article 7 cannot be applied to A.R.S. § 42-3371 without rewriting the language of the statutes in Article 7. For example, A.R.S. § 42-3302 is specifically tied to the tax rates in A.R.S. §§ 42-3251 and 42-3251.01. A.R.S. § 42-3302 makes no reference whatsoever to new

A.R.S. § 42-3371. Third, Chapter 3 of Title 42 also includes a luxury privilege tax that is *not* levied in on-reservation sales from tribes or tribal members to non-tribal members. *See* A.R.S. § 42-3052. Because Chapter 3 contains both tobacco taxes that are levied in on-reservation sales and are not levied in on-reservation sales, one cannot logically draw the conclusion that the language "in the manner provided by this chapter" indicates a clear intention to apply the new tax to on-reservation sales through Article 7. In addition, there are many provisions in Chapter 3 necessary for administering the tobacco tax collection process. There is no indication that the general direction to levy and collect in the manner of the chapter was intended to be more than a general direction to the Department to use its normal procedures of providing stamps to be affixed to packages of cigarettes by distributors. See Title 42, Chapter 3, Article 1 (General Administration), Article 4 (Enforcement) and Article 5 (Cigarettes, Cigars and Tobacco Products).

Furthermore, the state can only tax on-reservation sales from tribes or tribal members to non-tribal members if the legal incidence of the tax falls upon the non-tribal consumer. *Cal. State Bd. of Equalization v. Chemehuevi Indian Tribe*, 474 U.S. 9, 11 (1985) (state could require Indian tribe to collect cigarette taxes from non-Indian purchasers on reservation and remit to state only if legal incidence of tax was on non-Indian purchasers). In *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. at 12. However, 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, 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 203 failed to amend the Indian Reservation Tobacco Tax in Article 7 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."). Once again, the drafters of Proposition 203 could have easily incorporated the presumption contained in A.R.S. § 42-3303, but did not do so.

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."). Given that Proposition 203 fails to amend Article 7 of Title 42 to include new statute A.R.S. § 42-3371 in the Indian Reservation Tobacco Tax or otherwise include a provision stating that the legal incidence of the new tax is conclusively presumed to be on the consumer, the tax embodied in A.R.S. § 42-3371 cannot be interpreted to apply to on-reservation sales from tribes or tribal members to non-tribal members.

Regarding the application of the 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 203 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. § 42-3303(C). Given that Proposition 203 does not amend Article 7 to incorporate the

new tax set forth in A.R.S. § 42-32371, the luxury/excise tax setoff in Article 7 does not apply either.

Conclusion

The new tobacco tax established by Proposition 203 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 203 does not amend the Indian Reservation Tobacco Tax in Article 7 to incorporate or reference new statute A.R.S. § 42-3371, 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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