JURISDICTION: **OKLAHOMA TAX COMMISSION DECISION**
CITE: **2006-04-25-04 / PRECEDENTIAL**
ID: **N-00-011**
DATE: **APRIL 25, 2006**
DISPOSITION: **DENIED**
TAX TYPE: **INCOME TAX**
APPEAL: **NO APPEAL TAKEN**

HEARING EXAMINER'S REPORT

The above-named taxpayers protest the proposed assessment of income taxes on income received from the leasing of trust property and improvements in "Indian country." The parties are represented by counsel. After a hearing, and upon consideration of said protest, the files and records of the Oklahoma Tax Commission, and the evidence adduced in regard hereto, the undersigned makes the following findings of fact, conclusions of law, and recommendation as to the final disposition of said protest.

FINDINGS OF FACT

1. TAXPAYERS are husband and wife. MR. TAXPAYER is a member of the Kiowa Indian Tribe of Oklahoma, a federally recognized Indian tribe.

2. In 1986, MR. TAXPAYER purchased .53 acres of restricted Indian land for $3,800. The seller executed a deed to the land to the United States of America in trust for MR. TAXPAYER. MR. TAXPAYER became, and was at all times material herein, the beneficial owner of the land, located in LARGE CITY, Oklahoma. MR. TAXPAYER'S intention was to develop and use the land commercially.

3. In 1989 and 1990, at a cost of approximately $100,000, MR. TAXPAYER constructed a 60' x 100' air-conditioned steel building and graveled parking lot on the property, to house a Bingo hall and smoke shop.

4. In 1990, MR. TAXPAYER rented the property and improvements, then known as BINGO HALL AND SMOKE SHOP, to MR. TAXPAYER'S brother, BROTHER, for an initial period of one year with option to renew for two more years, at a rental rate of 60% of the net profits of the business or $12,000 per month, whichever was greater.

5. On May 1, 1992, MR. TAXPAYER leased the premises, except for the area of the building designated for the smoke shop, to ANOTHER Tribe for three years at a rental of $40,000 per month for the purpose of operating Bingo gaming and associated businesses.

6. For the tax years 1992, 1993 and 1994, taxpayers reported the income they received from these leases on their federal tax returns, and then, claiming it to be exempt from taxation pursuant to the provisions of *Squire v. Capoeman*, 351 U.S. 1 (1956) and IRS Rev. Rul. 67-284, deducted that income from their gross income. Taxpayers did not report the rental income to Oklahoma.

7. The IRS subsequently disallowed the claimed exemption and re-determined taxpayers' adjusted gross and taxable income and assessed additional taxes. Pursuant to regular procedures, the IRS subsequently provided the Tax Commission with a copy of the IRS's revenue agent's/service center reports detailing the IRS's re-determination of taxpayers' income.

8. Taxpayers challenged the IRS's determination and assessment in federal tax court. Prior to the determination by that court, taxpayers reached an agreed settlement with the IRS as to the amount of tax due. The settlement did not involve a re-determination of taxpayers' income by the tax court or by the IRS. (The IRS's initial determination of taxpayers' 1992 income was incorrect, however. This determination was subsequently corrected by the IRS and shown on their records.).

9. In response to the RARs, the Audit Division proposed assessments of additional Oklahoma income tax for 1992, 1993 and 1994, with penalty and interest, and taxpayers protest. The 1992 proposed assessment was amended on October 31, 2000, consistent with the IRS's corrected income determination for that year. As corrected, the amounts proposed to be assessed, and the amounts here in controversy, are:

1992
$19,553.00 - Additional tax
$22,145.78 - Interest through 10/31/00
$ 1,955.30 - Penalty
$44,654.08 - Total

1993
$19,638.00 - Additional Tax
$15,834.12 - Interest through 8/31/99
$ 1,963.80 - Penalty
$37,435.92 - Total

1994
$ 5,989.00 - Additional Tax
$ 3,930.58 - Interest through 8/31/99
$ 598.90 - Penalty
$10,518.48 - Total

10. MR. TAXPAYER acknowledges that, during the tax years in question, taxpayers did not live on a restricted Indian allotment or on land held in trust by the United States.

CONCLUSIONS OF LAW

1. In *Squire v. Capoeman*, 351 U.S. 1 (1956), the Supreme Court held that income received by non-competent Indians from the sale of standing timber on allotted land was exempt from federal income tax, based on the General Allotment Act of 1887. The Court made it clear that the exemption accorded tribal and restricted Indian lands extends to the income derived

directly from the land. The IRS recognized this exemption in Rev. Rul. 67-284, emphasizing that the exempt income must be "derived directly" from the land. Taxpayers argue here that, based on *Capoeman* and Rev. Rul. 67-284, the rental income received from the Bingo hall and smoke shop are exempt from any form of income taxation.

2. *Capoeman* and Rev. Rul. 67-284 are not unlimited in scope, however. In *Dillon v. United States*, 792 F.2d 849 (9th Cir. 1986), *cert. denied*, 480 U.S. 930 (1987), the court held that income earned by Indians through operation of smoke shops on Indian trust land was not income "derived directly" from the land; and was not exempt from income tax. In *Hoptowit v. Commissioner*, 78 T.C. 137 (1982), the court denied taxpayers' claim for an exemption from tax of income earned from a smoke shop located on the Yakima Indian reservation, and held that the taxpayer did not receive the smoke shop income principally "as a result of the use of reservation land and resources." In *Critzer v. United States*, 597 F.2d 708 (Ct. Cl.), *cert. denied*, 444 U.S. 920 (1979), the United States Court of Claims likewise held that income realized by an Indian land owner in the operation of a motel, restaurant and gift shop and from building rentals was not income directly derived from the land, and was not immune from federal income tax simply because the businesses were located on tax-exempt reservation land. The Court stated that the rental income was not derived from the direct exploitation or use of the land or its resources, but rather from business activities associated with improvements on the land. It found that the income failed to be exempt because it was primarily attributable to the utilization of the capital improvements constructed on the land and the management of those assets by the taxpayer. *Id.*, at 597 F.2d 713. In *Saunooke v. United States*, 806 F.2d 1053 (Fed. Cir. 1986), the income of enrolled members of the Eastern Band of the Cherokee Indians who operated gift shops, restaurants, motels and a gas station on possessory holdings of an Indian reservation was again held not derived directly from the land and not exempt from taxation. The same conclusion was reached in *Hale v. United States*, 579 F.Supp. 646 (E.D. Wash. 1984), where the court concluded that the income received by an enrolled member of the Yakima Indian Nation from leasing allotted land and a small building to a fellow tribal member was not derived directly from the land, and was not exempt from federal income tax. Likewise, the Internal Revenue Service's Chief Counsel has advised that "where the income does not stem primarily from exploitation of the land, the income does not qualify as income derived directly from the land. For instance, where the income is derived primarily from capital improvements to the land and/or the Indian's labor, the income cannot be said to be derived directly from the land." IRS CCA 200111044, 2001 W.L. 260658 (IRS CCA). The rental income here, derived from taxpayers' lease of the commercial buildings, is not exempt from income tax under either *Capoeman* or the IRS revenue ruling.

3. Taxpayers also argue that the State of Oklahoma is prohibited from taxing the income earned by them on trust land. Taxpayers acknowledge, however, that they did not live on trust or allotment land during the tax years in question, and the United States Supreme Court has held that Oklahoma may tax the income of all persons, Indian and non-Indian alike, residing in the State outside Indian country. *Oklahoma Tax Commission v. Chickasaw Nation*, 515 U.S. 450, 115 S.Ct. 2214 (1995).

4. Taxpayers' protest should be denied.

WAIVER OF PENALTY AND INTEREST

The facts of this case demonstrate that taxpayers' claim of exemption was based upon a good faith misunderstanding of the law regarding whether this income was subject to taxation by the State. The penalty and interest ordinarily accruing, therefore, may be waived by the Commission pursuant to 68 O.S. Supp. 1997, §220.

DISPOSITION

The foregoing protest should be denied, and the proposed assessment of deficient taxes should be adjudged due and owing. The penalty and interest assessed or accruing to the date of the Commission's order herein, and for a period of 30 days thereafter, should be waived.