

BEFORE THE ARIZONA DEPARTMENT OF REVENUE

In the Matter of	)	DECISION OF
	)	HEARING OFFICER
[REDACTED]	)	
	)	Case Nos. 200900021-I (2001)
UTI # [REDACTED]	)	200900022-I (2002)
_____	)	

This matter is between [REDACTED] (Taxpayer) and the Individual Income Tax Audit Section (Section) of the Arizona Department of Revenue (Department). At issue is the propriety of the Section's proposed assessments of income tax and interest for tax years 2001 and 2002. Taxpayer requested that a hearing be held through the submission of written memoranda.

Taxpayer's Opening Memorandum/letter was timely filed by postmark dated March 13, 2009. The Section timely filed its Response Memorandum on April 10, 2009 with the Hearing Office. However, the copy sent to Taxpayer was returned by the Post Office. The Section resent the Response Memorandum to Taxpayer's mailing address in [REDACTED], Arizona and the Hearing Office granted Taxpayer additional time to file her Reply Memorandum. Taxpayer timely filed her Reply Memorandum via postmark dated May 21, 2009. However, the Reply Memorandum was sent to the Office of Administrative Hearings rather than the Department's Hearing Office. It was subsequently delivered to the Hearing Office, and this matter is now ready for ruling.

FINDINGS OF FACT

Taxpayer is an enrolled member of the [REDACTED] Tribe. During the years at issue, Taxpayer worked for [REDACTED]

("[REDACTED]") at their [redacted] Office,<sup>1</sup> and received wages of \$[REDACTED] in 2001 and \$[REDACTED] in 2002. Taxpayer also received wages of \$[REDACTED] in 2001 from [REDACTED] ("[REDACTED]"), also located in [redacted]. During this time, Taxpayer resided at both [REDACTED], AZ (on the [REDACTED] Reservation) and in [redacted] and travelled back and forth between the two on weekends. However, Taxpayer asserts that her "main residence" was her home on the reservation.

On the [REDACTED] Reservation, Taxpayer has a homesite lease, a house, and livestock with a grazing permit from the [REDACTED] for use of certain land on the reservation. [REDACTED] Company ("[REDACTED]") entered into a lease agreement to mine for coal on the [REDACTED] Reservation, portions of which covered land for which Taxpayer had a grazing permit. [REDACTED] mining activity caused damage to the land, and subsequently entered into an agreement(s) with the [REDACTED] to compensate the [REDACTED] land users for the damage done to the land for which they were granted use. Pursuant to such agreement(s), Taxpayer received a \$[REDACTED] payment from [REDACTED] in 2001 to compensate her for the lost value of her grazing land. In 2002, Taxpayer received a \$[REDACTED] payment from [REDACTED], presumably for the same reasons. Taxpayer subtracted these amounts from her 2001 and 2002 Arizona income tax returns based upon her belief that such income was not taxable by the State of Arizona. Taxpayer did not

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<sup>1</sup> According to its website, [REDACTED]

subtract the income she received from [REDACTED] and [REDACTED] on her Arizona income tax returns for the years at issue.

The Section subsequently audited Taxpayer's 2001 and 2002 Arizona income tax returns. As a result of the audits, on March 22, 2006, the Section issued a Notice of Proposed Assessment for tax year 2001 disallowing the \$[REDACTED] subtraction taken. The Section issued another Notice of Proposed Assessment on March 28, 2007 for tax year 2002 disallowing Taxpayer's subtraction in the amount of \$[REDACTED]. The assessment for tax year 2002 noted that the payment from [REDACTED] did not meet the requirements for exempt Native American wages.

Taxpayer timely protested both assessments. With both protests, she asserted that she is a Native American ([REDACTED]) and that she resides on the [REDACTED] Reservation at [REDACTED].<sup>2</sup> With her protests, she attached utility bills from 2001 and 2002 showing that she did reside and use electricity at her home on the reservation during the years at issue. She also asserted that because the money received from [REDACTED] was to compensate her for the lost value of her grazing land on the reservation, it was not taxable by the State of Arizona.

The Section issued two letters to Taxpayer on September 11, 2006. The first letter, pertaining to tax year 2001, requested that Taxpayer provide the Section with "a copy of the ruling issued by the [REDACTED] District Court regarding the damage done

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<sup>2</sup> As noted above, Taxpayer travelled back and forth between the reservation and [redacted] during the years at issue. Based upon the lack of evidence provided, it is not known exactly how much time she spent in each place.

to [Taxpayer's] property when the grazing rights were exercised." The second letter, pertaining to tax year 2002 asked Taxpayer to provide the Section with "a copy of [Taxpayer's] federal return and include all schedules, W-2(s) and 1099-MISC(s)" and also requested "backup documentation for Schedules D & E." Taxpayer provided all of the information requested in the Section's letters, including court rulings and agreements pertaining to the compensation for damage to the grazing land.

The Section did not modify the assessments, and the matters were forwarded to the Hearing Office. At issue is the propriety of the Section's proposed assessments for tax years 2001 and 2002.

#### CONCLUSIONS OF LAW

Arizona Revised Statutes (A.R.S.) § 43-102.A.4 states that "[i]t is the intent of the legislature . . . [t]o impose on each resident of this state a tax measured by taxable income wherever derived." However, there are some exemptions in cases involving income earned by Native Americans.

Arizona tax law was the impetus for a decision dealing with the taxation of income earned by Native Americans. In *McClanahan v. Arizona State Tax Comm'n*, 411 U.S. 164 (1973), the U.S. Supreme Court concluded that income earned from employment on the [REDACTED] Reservation by a [REDACTED] Native American who resided on the [REDACTED] Reservation was not subject to the Arizona income tax. In general, the Court determined that a state had no right to tax income earned on a reservation by a Native American who both lives and earns money on his or her reservation. In *State ex rel. Arizona Department of Revenue v. Dillon*, 170 Ariz.

560, 566, 826 P.2d 1186 (App. 1991), the Arizona Court of Appeals stated that “[i]t is the tribal status of the individual upon whom the incidence of the tax falls that is relevant in determining the *McClanahan* tax exemption.”

The Arizona Statutes do not address taxation of Native Americans. However, based upon various court cases, the Department has issued an Income Tax Ruling addressing its position on income taxation of Native Americans. See Arizona Individual Income Tax Ruling (ITR) 96-4. Tax rulings issued by the Department are public written statements of the Department’s position interpreting Arizona tax law and apply the law to a specific set of facts or a general category of taxpayers. See Arizona General Tax Ruling (GTR) 08-1. Rulings are issued when the Department determines that they are necessary or helpful in effective tax administration, usually where a problem affects a large number of taxpayers or is recurring.

ITR 96-4 provides, in part, as follows:

1. In general, an Indian is subject to the Arizona state income tax unless the Indian (1) is living and working on the reservation, and (2) is deriving income from reservation sources only, and (3) is an affiliated member of the tribe for which that reservation was established. Any income derived from nonreservation sources by an Indian is subject to the Arizona state income tax. *Arizona will not impose tax on an Indian's income derived from reservation sources if the Indian lives on the reservation and the Indian is an affiliated member of the tribe for whose benefit that reservation was established.* (Emphasis added).

A review of Taxpayer’s 2001 Arizona return indicates that Taxpayer reported her Federal Adjusted Gross Income (FAGI) from

all sources as \$[REDACTED] and subtracted the \$[REDACTED] payment from [REDACTED]. In 2002, Taxpayer reported her FAGI from all sources as \$[REDACTED] and subtracted the \$[REDACTED] payment from [REDACTED]. The subtracted payments from [REDACTED] are the income items at issue.

The Section asserted in its memorandum that Taxpayer lives and works off the reservation in [redacted] during the week; therefore, she does not meet the requirements of ITR 96-4 and *McClanahan*. Consequently, the Section argues that Taxpayer cannot subtract the payments from [REDACTED].

Taxpayer asserts that she maintains her domicile on the reservation and that the income at issue comes from reservation sources. In addition, Taxpayer argues that reservation residency and/or the "existence of income from arguably non reservation sources" is not material in this case because of the uniqueness of the income at issue. Therefore, she asserts that the income from [REDACTED] is not taxable by Arizona.

With respect to ITR 96-4, the first sentence of Paragraph One of the Conclusion and Ruling section suggests that a taxpayer is subject to Arizona state income tax unless he/she meets all three prongs of the test. See ITR 96-4. For the years at issue, Taxpayer clearly met the third prong of the ruling, whereas she was "an affiliated member of the tribe for which that reservation was established." *Id.* Taxpayer likely lived on the reservation,

but did not seem to be "working<sup>3</sup> on the reservation." *Id.* Therefore, it is questionable as to whether she met the first prong. Finally, because she had some income that was arguably from non-reservation sources (i.e. from [REDACTED] in [redacted]), she did not likely meet the second prong, which requires that the individual derives his/her "income from reservation sources only." *Id.* (Emphasis added.) Therefore, pursuant to the first sentence of Paragraph One of ITR 96-4's Conclusion section, Taxpayer was subject to Arizona state income tax during 2001 and 2002.

However, this does not mean that all of Taxpayer's income was subject to tax. Rather, it simply means that she was not completely exempt from Arizona income tax. Sentences two and three of Paragraph One of ITR 96-4's Conclusion section discuss which portions of her income are taxable.

Sentence two provides that "[a]ny income derived from nonreservation sources by an Indian is subject to the Arizona state income tax." Therefore, Taxpayer's income from [REDACTED] and [REDACTED] were subject to Arizona income tax because they were not located on the [REDACTED] Reservation. Indeed, Taxpayer did not deduct the income from these sources on her 2001 and 2002 Arizona income tax returns.

Sentence three of Paragraph One of the Conclusion section provides that "Arizona will not impose tax on an Indian's income derived from reservation sources if the Indian lives on the

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<sup>3</sup> As Taxpayer points out in her Reply Memorandum, this prong may not always be relevant where the income at issue is not from the taxpayer's labor activities, but rather from a land source.

reservation and the Indian is an affiliated member of the tribe for whose benefit that reservation was established." *Id.* There is no dispute that Taxpayer was an affiliated member of the [REDACTED] Nation. However, there is some question as to whether the income was "derived from reservation sources" and whether Taxpayer "lived" on the reservation. *Id.*

With respect to whether the income was from reservation sources, Taxpayer was given a grazing permit from the [REDACTED] Nation to graze cattle and sheep on such land located on the [REDACTED] Reservation. The income Taxpayer received in 2001 and 2002 from [REDACTED] was to compensate her for the lost value of her grazing land (due to [REDACTED] mining activities). Land use and rights would certainly be connected to a reservation source. It seems logical that compensation for destruction to such reservation land would also be "derived from reservation sources."<sup>4</sup>

However, the source of the income and the tribal status of the Taxpayer alone are not sufficient to exempt an item of income from state tax liability. "The residence of a tribal member is a significant component of the *McClanahan* presumption against state tax jurisdiction." *Oklahoma Tax Comm'n v. Sac and Fox Nation*, 508

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<sup>4</sup> The Supreme Court found that income to a tribal member from a logging company for foresting trees on the allotted land was derived from such land and was not taxable. *Squire v. Capoean*, 351 U.S. 1 (1956). Additionally, in *McClanahan*, the Court noted the Supreme Court has "unambiguously rejected state efforts to impose a land tax on reservation Indians." *McClanahan*, 411 U.S. at 169 (citing *The Kansas Indians*, 5 Wall. 737 (1867)). The *McClanahan* Court later added that "the State has no more jurisdiction to reach income generated on reservation lands than to tax the land itself." *Id.* at 181.

U.S. 114, 123 (1993). Thus, one of the requirements for exemption is that the tribal member must be "living on the reservation." *Id.*; see also ITR 96-4.

Unfortunately, the parties provided very little information or evidence on the issue of residency. As a basis for concluding that Taxpayer cannot deduct the income from [REDACTED], the Section states in its memorandum that "Taxpayer lives and works off the reservation in [redacted] during the week." However, the only evidence provided for the statement was a citation to a letter from Taxpayer's employer stating that Taxpayer "travels weekly from the reservation to work in the [redacted] Office and maintains her residence in [REDACTED]." Neither party provided any evidence as to specific amounts of time Taxpayer spent in [redacted] compared with the time spent on the reservation.

Taxpayer asserts that although she traveled to [redacted] at various times during the years at issue, she maintained her domicile and lived on the reservation during 2001 and 2002. Taxpayer had a home that was located on the reservation. With her protest, Taxpayer provided copies of utility bills issued by the [REDACTED] Tribal Utility Authority that were issued in Taxpayer's name to what was presumably a residence on the reservation. Taxpayer also stated in her protest that she owned 34 head of cattle and sheep that grazed on land allotted to her on the reservation. The Section did not refute this, nor did it provide facts to show that Taxpayer's primary residence was in [redacted] rather than the reservation. Based on the limited facts available, Taxpayer has provided enough evidence to establish that

she did live on the reservation at times during the period at issue.<sup>5</sup>

Based on the foregoing, the Hearing Office finds that Taxpayer's income received from [REDACTED] in tax years 2001 and 2002 are exempt from Arizona income tax.

Therefore, Taxpayer's protests of the assessments for the 2001 and 2002 tax years are granted.

DATED this 26th day of June, 2009.

ARIZONA DEPARTMENT OF REVENUE  
HEARING OFFICE

[REDACTED]  
Hearing Officer

Original of the foregoing sent by certified mail to:

[REDACTED]

Copy of the foregoing delivered to:

Arizona Department of Revenue  
Individual Income Tax Audit Section

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<sup>5</sup> The extent to which a taxpayer must be "living" on the reservation in order to qualify for the exemption is not stated in the Department's ruling, nor is it addressed in the cases cited in the parties' memoranda.