

**Office of Chief Counsel
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memorandum**

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subject: Allotted Lands

This is in response to your request for our opinion as to whether the income received by
Taxpayers from leases of allotted property is exempt from federal taxation.

LEGEND

Taxpayers=
Wife=
Husband=
Tribe X=
Tribe Y=
Reservation=
Tax Year=
the Act=
\$A=
\$B=
\$C=
\$D=
\$G=
\$H=

\$I=
 \$J=
 \$L=
 \$X=
 \$Y=
 \$M=
 \$N=
 YYYY=
 Country Club=
 E%=
 F%=
 K%=
 L%=
 R%=
 FFFF=
 P=
 Q=
 GGGG=
 O=
 HHHH=
 L=

ISSUES

Whether federal income tax is owed on rent received by a member of the Tribe from (1) sixty-five year leases of the taxpayer's allotted, restricted federal trust, which provide for economic development of the land as a country club and condominiums, and (2) ten-year agreements permitting the construction of advertising billboards on the taxpayer's restricted, allotted lands?

CONCLUSION

Whether or not the rent attributable to improvements on the land and calculated with respect to revenues generated by those improvements is subject to federal income tax depends upon whether it is derived directly from the land. After balancing the limited legal authority addressing this question, the Service's existing published guidance, and the specific facts of this case, we conclude that the income paid to Taxpayers is reasonably viewed as derived directly from the land and therefore exempt from Federal income tax under the Act and *Squire v. Capoeman*.

FACTS

I. Taxpayer's Reported Rental income from Allotted Lands

The present Reservation was first established by executive order.¹

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At the present time, we do not have enough information to assert which order relates to the parcels at issue.

Wife is a member of Tribe X and Husband is a member of Tribe Y. In Tax Year 20XX the taxpayers filed a joint income tax return which reported X in gross income, all apparently received from their respective tribes and tribal enterprises. The taxpayers also reported Y in rental income on Schedule E, line 3, as follows:

Description /Lot #	Amount
Condominium 1	\$A
Condominium 2	\$B
Condominium 3	\$C
Billboards	\$D

The taxpayers claim that the above described rental income is exempt from federal income tax because it is received as a result of the lease of allotted Indian Trust land held for the benefit of Wife. Accordingly, the taxpayers did not include the rental income reflected on the Schedule E on the face of the Form 1040, although rental income would normally be listed on Line 17.

II. Leases of Taxpayer's Allotted Lands

A. Condominium 1

In YYYY, the United States government entered into a sixty-five year lease on behalf of a number of individual allottees with the Country Club. Wife was represented by a guardian in entering into the lease because she was a minor. Wife was to receive E% of the lease payments as her proportionate share of the total payments made by the Country Club for the lease of her allotted land. The lease provision provided that the allottees would receive minimum guaranteed annual rent plus varying percentages of the gross receipts from retail and service enterprises and gross receipts from rental or subleasing of residential and commercial units:

A specific clause states that the parties are not in partnership, but that the lessee will operate the businesses in good faith "so that Lessor will at all times receive the maximum

income under the percentage rent provisions of this lease.” To the extent the rental payments were not made timely, the lessor was entitled to F% interest.

The lease also required that the lessee construct, within three years, permanent improvements that had a fair market value of \$G and within five years the improvements had to have a fair market value of \$H. All improvements will become the property of the lessor upon termination of the lease. Architect’s plans were required to be submitted for approval within 180 days of the lease’s effective date.

If the property was to be used for anything other than the above, the parties would negotiate the percentage of the gross revenue that the lessor would be entitled to. An annual accounting is to be provided to the lessor by the lessee. Several supplemental lease agreements were subsequently entered into by the taxpayer:

B. Condominium 2

In FFFF, P, entered into a lease of twenty acres of Wife’s allotted land for a period of sixty-five years. The purpose of the lease was to construct a condominium complex. The lease provided that the lessee would pay a guaranteed minimum annual rental, which began at \$I for the first year, increased to \$J in the fourth year, and thereafter increased or decreased based upon a cost of living factor. In addition, the lessor was to receive the difference between the guaranteed annual rental and K% of the condominium subleases.

Within the first year of the lease, the lessee was required to begin construction on fifty condominiums that had a total market value of \$L. The lease also provided for the complete construction of an additional ninety condominium units. The lease agreement, however, did not specify when the construction was to be completed or what the fair market value of the condominiums would be. If improvements were not completed as provided, the lessor had the option to either modify the lease to exclude the unimproved portions or cancel the lease.

At the end of the lease period, all improvements would revert to the lessor. The lease provided for an annual accounting by the lessee. The annual accounting statements have not been made available to the ITG agent or the undersigned attorney.

3. Condominium 3

In FFFF, Q entered into a lease with Wife and two other Tribal members for the lease of three parcels of property. The lease provided that the lessors would receive one-third each of a minimum guaranteed annual rental amount, in addition to varying percentages of the gross receipts from retail and service enterprises and gross receipts from rental or subleasing of residential and commercial units:

The minimum annual rental is subject to a cost of living increase up to five percent each year. The lessee was also required to construct improvements with a fair market value of \$M within four years from the beginning of the lease, which would then revert to the lessors upon the termination of the lease. If the lessee used the premises for anything other than as described above, the lessors and lessee would negotiate a percentage rental of that use. If improvements were not completed as provided, the lessors had the option to modify the lease to exclude the unimproved portions, cancel the lease, or charge an increased amount of rent until the improvements were completed.

The lease provided for an annual accounting by the lessee.

In GGGG, the lease was amended when the guaranteed annual rental, after the cost of living adjustment, became greater than the rents received by the lessee. The lease was amended to reflect that the guaranteed annual rental would be \$N, without a cost of living adjustment or 100% of the rents received by the lessee, whichever amount was larger.

III. Billboard Permits on Taxpayer's Allotted Lands

In HHHH, Wife entered into agreements. The agreements allowed L to erect, place, construct and maintain an outdoor advertising structure (a billboard) on permittor's land for a period of ten years, and granted an accompanying right of access for that purposes.

As remuneration for this permit, Wife would receive a permit fee (which may have been paid to either the BIA or to Wife directly), a guaranteed minimum annual rental, which increases by a cost of living factor up to L% each year, plus R% of any net rental income above the guaranteed minimum annual rental.

The permittee is required to restore the property to its original condition upon termination of the lease to provide an annual accounting of the gross income from the rental of the sign.

The agreement provided for an annual accounting by the permittee.

IV. Common Recitals in Lease Agreements on Taxpayer's Allotted Lands

All of the agreements described above contain a recital stating that no lease provisions are intended to constitute a waiver of applicable laws providing tax immunity to trust or restricted Indian property, interests in trust or restricted Indian property, or income from trust or restricted Indian property. The lease agreements, except for the billboard permits, also contain a recital that the terms of the rental payments do not create a partnership between the Lessors and the Lessees.

LAW AND ANALYSIS

Indians are citizens like any other and "in the ordinary affairs of life, not governed by treaties or remedial legislation, they are subject to the payment of income taxes as are other citizens."² Accordingly, unless a taxpayer has evidence that either a treaty or an act of Congress exempts his income from taxation, it is taxable.

² *Squire v. Capoeman*, 351 U.S. 1 (1956).

[However, the language in a treaty or statute] need not explicitly state that Indians are exempt from the specific tax at issue; it must only provide evidence of the federal government's intent to exempt Indians from taxation. Treaty language such as "free from incumbrance," "free from taxation," and "free from fees," are but some examples of express exemptive language required to find Indians exempt from federal tax.³

Furthermore, where a statute or a treaty governing affairs between the government and Indians, as wards of the nation, is ambiguous, the statute or treaty is to be resolved in favor of the Indians.⁴ "Doubtful expressions are to be resolved in favor of the weak and defenseless people who are the wards of the nation, dependent upon its protection and good faith."⁵

I. The General Allotment Act and the Act

Under the General Allotment Act of 1887 individual Indians were allotted land on their reservations. These lands were to be held in trust by the United States government for a period of 25 years.⁶ At the end of the trust period, which has been extended indefinitely by executive order, the individual Indians would receive title in fee simple to the allotted land, "discharged of said trust and free of all charge or incumbrance whatsoever."⁷

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II. *Squire v. Capoeman*

In *Squire v. Capoeman*,⁹ the Supreme Court considered whether the proceeds received by a member of an Indian tribe from the sale of timber on his allotted land were excludable from the member's income. The Court looked to the provision of the General Allotment Act of 1887 that stated that restricted land was to be conveyed to the individual in fee at the end of the trust period "free of all charge or encumbrance," and concluded that the timber sale

³ *Ramsey v. U.S.*, 302 F.3d 1074, 1078-79 (9th Cir. 2002).

⁴ *Capoeman*, 351 U.S. at 6-7 (1956); see also *Carpenter v. Shaw*, 280 U.S. 363, 367 (1930).

⁵ *Id.*

⁶ Ch. 119, 24 Stat. 388 (1887). The General Allotment Act as later codified at 25 U.S.C. 348.

⁷ 25 U.S.C. § 348.

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⁹ 351 U.S. 1 (1956).

proceeds were not subject to federal income tax.¹⁰ The Court interpreted the statute in favor of tribal members, in light of their status as “wards” of the United States government:

Hence in the words of Chief Justice Marshall: ‘The language used in treaties with the Indians should never be construed to their prejudice. If words be made use of, which are susceptible of a more extended meaning than their plain import, as connected with the tenor of the treaty, they should be considered as used only in the latter sense.’¹¹

The Court found that the exemption from charges on the land extended to the income “directly derived therefrom.”¹² The restricted, allotted trust land beneficially held by the taxpayer in *Capoeman* was old growth forest land, unsuitable for agriculture and “of little value after the timber was cut.”¹³ The income at issue was received by the United States on behalf of the taxpayer for the sale of that timber.¹⁴ The Court reasoned that after the timber on the trust land allotted to the individual Indian taxpayer was removed, the value of the land was diminished, and income from the timber necessarily had to be preserved so that the individual would be able to support himself after the trust period ended and the individual received title to the land free of restrictions.¹⁵ The Court distinguished income generated by reinvesting the income from timber sales and concluded that reinvestment income is not exempted from federal income taxation.¹⁶

Courts have held that income of the following types is exempt from federal income tax because they are derived directly from the land: farming and ranching,¹⁷ oil and gas income,¹⁸ and royalty income from mineral deposits.¹⁹

However, in *Dillon v. U.S.*,²⁰ the Ninth Circuit held that income a tribal member derived from operating a smokeshop on the tribal member’s allotted land is not directly derived from the land, and, therefore, is included in gross income for federal income tax purposes. Recognizing that other courts had excluded income generated by conducting businesses involving agriculture or natural resources on allotted land, *Dillon* concludes that the taxpayer’s income was different in that it was “earned primarily through a combination of [the taxpayer’s] labor, the sale of goods produced off the reservation, and improvements constructed on trust land.”²¹

¹⁰ *Id.* at 8-9 (1956). The holding in *Capoeman* was cited with approval in a recent Supreme Court case interpreting a 1994 Act to find no express tax exemption was provided. *Chickasaw Nation v. U.S.*, 534 U.S. 84, 85 (2001).

¹¹ *Id.* at 7 (Chief Justice Warren quoting Chief Justice Marshall. See, *Carpenter v. Shaw*, 280 U.S. 363, 367 (1930).

¹² *Id.* Previously the Supreme court had held income from reinvesting the income arising from restricted Indian trust property was taxable in *Superintendent of Five Civilized Tribes v. Commissioner*, 295 U.S. 418 (1935). Courts have continued to distinguish reinvestment income from income derived directly from the lands.

¹³ *Capoeman*, 351 U.S. 1, 4 (1956).

¹⁴ *Id.* at 4-5.

¹⁵ 351 U.S. 10.

¹⁶ *Squire*, 351 U.S. at 9.

¹⁷ *Stevens v. Commissioner*, 452 F.2d 741 (9th Cir. 1971).

¹⁸ *United States v. Daney*, 370 F.2d 791 (10th Cir. 1966).

¹⁹ *Hayes Big Eagle v. United States*, 300 F.2d 765 (Ct. Cl. 1962).

²⁰ 792 F.2d 849 (9th 1986).

²¹ *Id.* at 855.

III. Service Position

The Service follows the *Squire v. Capoeman* test.²² In Rev. Rul. 67-284, the Service provided a complete description of its position on when income associated with restricted trust land is excluded from gross income for federal income tax purposes.²³ The ruling sets forth five tests and holds that if all five tests are met, the income is excluded. The tests are as follows: (1) the land in question must be held in trust by the United States; (2) such land must be restricted and allotted and held for an individual noncompetent Indian, and not for a tribe; (3) the income must be derived directly from the land; (4) the statute, treaty or other authority involved must evince congressional intent that the allotment be used as a means of protecting the Indian until such time as he becomes competent; and (5) the authority in question must contain language indicating clear congressional intent that the land, until conveyed in fee simple to the allottee, is not to be subject to taxation.

The ruling holds that income exempt under the *Capoeman* decision includes “rentals (including crop rentals), royalties, proceed from the sale of the natural resources of the land, income from the sale of crops grown upon the land and from the use of the land for grazing purposes, and income from the sale or exchange of cattle or other livestock on the land.” Rev. Rul. 67-284 at 55. However, the ruling does not say that this list is comprehensive, nor does it define the scope of what is covered by rentals.

Here, the Taxpayers clearly meet four out of the five tests. First, the Taxpayers’ land is held in trust by the United States. Second, the land is restricted and allotted and held for the taxpayer in accordance with the Act. Third, the Act, per *Capoeman*, evinces congressional intent that the allotment be used as a means of protecting the taxpayer. Finally, the Act contains language indicating congressional intent that the land, until conveyed in fee simple to the allottee, is not subject to taxation. The only test left unresolved is whether the income is derived directly from the land.

IV. Treatment of Rent Calculated With Respect to Business Proceeds

The terms and operation of Wife’s leases tie the amount of rent she receives to business activities to be conducted on the allotted land:

- All of the leases contemplate additional rent from specified business activities.
- Each of the three leases at issue states that the purpose is for business development of recreational, commercial, and residential buildings and that the lessee is under an obligation to begin building the valuable improvements in the first years of the lease. Several parcels of Wife’s land were released from Condominium 1 Lease, and the rent adjusted accordingly, when it was determined that no development would be possible on those parcels.
- Condominium 1 Lease specifically obligates the operation of the country club businesses so as to ensure maximum rent based upon the percentage of business.
- Condominium 3 Lease, was amended in HHHH to provide that it is possible for Wife to receive 100% of the sublease rental income received from the condominiums that

²² See Rev. Rul. 56-342, 1956-2 C.B. 20; Rev. Rul. 62-16, 1962-1 C.B. 7; Rev. Rul. 67-284 1967-2 C.B. 55.

²³ 1967-2 C.B. 55, *modified by* Rev. Rul. 74-13, 1974-1 C.B. 14

have been built on her restricted, allotted land when her guaranteed annual rent exceeded the actual amount of rent being collected from the improvements.

There are several cases holding that income from operating businesses such as motels, restaurants, and gift shops on allotted land, as well as rent on shops and apartments on allotted land is taxable.²⁴ However, in those cases, the tribal member with the allotted, restricted Federal trust land was also involved in operating the businesses, a factor the courts relied upon in making their determination. Indeed, the Court of Federal Claims, in *Saunooke v. U.S.*, noted the incongruity between taxing income from operating businesses on the land and taxing rent received from individuals operating businesses on the land:

At the heart of this controversy is the anomaly, pointed out by plaintiffs, that if an Indian rents his possessory holding to someone who operates a gift shop, his rental income is tax exempt, but if the same Indian is industrious enough to run the business himself, the income allocable to rent is taxable.²⁵

*Hale v. United States*²⁶ is the sole case to address comparable facts to this case. The taxpayer was a tribal member who received income from leasing allotted land as the site for a smokeshop. The lease set the rent at one third of the gross sales receipts from cigarettes. The tribal member receiving the rent had no involvement in operating the smokeshop. The court held that the income was taxable and not directly derived from the land because there was no exploitation of the land itself nor did the activity that generated the income diminish the value of the land.

The dissent in *Cross v. Comm'r*²⁷ lays out the argument for not taxing rent that is calculated based on business revenues. It describes the history of the directly derived test and how it came to be adopted in *Squire v. Capoeman* and concludes that the test is intended to be quite broad and serves only to distinguish income generated by the land, which is not subject to tax, from income generated by reinvestment, which is subject to tax.

After balancing the limited authority available, the Service's published position in Rev. Rul. 67-284, and the specific facts of this case, we conclude that the rents received by Taxpayers are reasonably viewed as derived directly from the land. Chief Justice Warren's opinion in *Squire v. Capoeman* stated that treaties and legislation are to be construed in a manner favorable to tribal members that have the status of wards of the Federal government. Furthermore, Rev. Rul. 67-284 describes "rentals" as a category of income that is excluded from taxation as derived directly from the land without conditioning that treatment on how the rents are calculated. Taxpayers are not involved in operating any of the businesses generating the rental income nor will she have an ownership interest in the improvements on the allotted land until after the lease term ends.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse affect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

²⁴ See, e.g., *Critzer v. U.S.*, 220 Cl.Ct. 43 (1979); *Saunooke v. U.S.*, 9 Cl.Ct. 537 (1986).

²⁵ *Id.* at 545.

²⁶ 579 F. Supp. 646 (Eastern Dist. Wash. 1984).

²⁷ 83 T.C. 561 (1986) (Parker, J., Dissenting in part).

If you have any questions please do not hesitate to contact Sylvia Hunt at (202) 622-7215 or Casey A. Lothamer at (202) 622-8464.

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