DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

WTA-N-139414-01
EO2:

MEMORANDUM FOR: Director, Indian Tribal Governments
Attn: Therese Nosie

FROM: Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities) CC:TEGE

SUBJECT: Request for Opinion: Income from Arts and Crafts

This Chief Counsel Advice responds to your request dated June 11, 2001, for counsel opinion with respect to the following issue. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Region A = [redacted]

Tribe B = [redacted]

ISSUES

I. Is income received by individual tribal members from the sale of arts and crafts made on federal trust allotted land exempt from federal income tax because the income is directly derived from the land?

II If the income is derived in part from the tribe member's labor to produce the products and, in part, directly derived from federal trust allotted land, does this affect its taxability?

III If the income is directly derived from leased land rather than federal trust allotted land under the General Allotment Act of 1887 does this affect its taxability?

IV If the income is derived from the sale of products made from resources directly derived from a tribal member's own allotted land, does this affect its taxability?

CONCLUSIONS

I. Tribal member's income directly derived from arts and crafts made from plants or animals grown or raised on federal trust allotted land is exempt from tax if the income is primarily derived from those materials.

II. Income directly derived from the sale of items produced on allotted land is not exempt from federal income tax if the income is derived primarily from labor or from the use of equipment.

III. Income directly derived primarily from unallotted tribal land that has been leased by an individual tribal member from the tribe is not excluded from the gross income of the lessee for purposes of federal income tax.

IV Income directly derived primarily from natural products grown on unallotted tribal land is not exempt from taxation when received by a tribal member.

FACTS

Members of Indian tribes produce native crafts which they market locally as well as world-wide. Some of the products are made entirely from items taken from the land, and some are made from purchased items. The crafts include pottery, basketry, dolls, and rugs.

The majority of the tribes of the Region A did not receive allotments under the General Allotment Act of 1887, ch 119, 24 Stat. 388, 25 U.S.C. §§ 331 et seq.. However, they were affected by the Indian Reorganization Act of 1934, ch 576, 48 Stat. 984, 25 U.S.C. §§ 461 et seq. (IRA). Generally, the land is held in trust and leased to tribal members for periods of 25 to 40 years, depending on the tribe. In the case of the Tribe B, the land is held communally.

LAW AND ANALYSIS

In Squire v. Capoeman, 351 U.S. 1, 8-9 (1956) the Supreme Court held that income received by a member of an Indian tribe is excluded from federal income tax when it is directly derived from federal trust land allotted under the General Allotment Act of 1887 (GAA).

Rev. Rul. 67-284 1967-2 C.B. 55, sets forth five tests that must be met for income to be excludible: (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.

This memorandum will first consider the requirement that income be derived directly from the land and, second, the type of land from which the income is required to be directly derived.

I. When is income "directly derived from the land"?

Income derived directly from the land includes rentals (including crop rentals), royalties, proceeds of sales of the natural resources of such land, income from the sale of crops grown on the land, income from the sale of livestock raised on the land, and income from the use of the land for grazing purposes. Rev. Rul. 62-16, 1962-1 C.B. 7, modified, Rev. Rul. 74-13, 1974-1 C.B. 14. Where the income is not derived 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 tribal member's labor, the income cannot be said to be derived directly from the land. See Critzer v. United .States, 220 Ct. Cl. 43, 597 F.2d 708 (1979), cert. denied 444 U.S. 920 (1979) (income from operation of motel is not derived directly from the land).

The courts have used two slightly different standards for determining whether income is directly derived from the land. In Beck v. Commissioner, 67 T.C.M. 2469, 2472 (1994), the court distinguished income received from activities that diminish the value of the land from income received from activities that are a result of capital investment or labor, although the activity takes place on land held in trust. However, in Dillon v. United States, 792 F.2d 849, 855-56 (9th Cir. 1986) aff'g, Cross v. Commissioner, 83 T.C. 561 (1984), the Ninth Circuit concluded that the "exploitation" rationale did not adequately describe the scope of the "derived directly" standard. It stated than an "exploitation" rationale could not adequately explain why income generated from ranching and farming was exempted from income taxation because, unless done improperly, these activities do not exploit the land. The court concluded that only income that was "generated principally from the use of reservation land and resources" is derived directly from the land.

II Is allocation between exempt income attributable to land and non-exempt income attributable to labor or use of equipment permitted?

The issue of allocation was first raised by the court in Critzer v. United States, 220 Ct. Cl. 43, 53 (1979), where the court suggested that allocation of income into exempt and nonexempt portions might be appropriate in some cases. In that case, the taxpayer did not request allocation so the court did not rule on the issue. In Critzer, a member of the Cherokee tribe sought exemption for income received from the operation of a motel, a restaurant, a gift shop and from the rental of a craft shop and apartment units. The court held the income was not exempt under Capoeman.

The courts denied taxpayers' requests to allocate income between exempt and unexempt categories in three cases: In Beck v. Commissioner, 67 TCM 2469 (1994) the taxpayer argued that the portion of the rental income equal to the fair market value of the rental of the trust property was directly derived from the land and should be exempt from income tax. In Saunooke v. United States, 806 F.2d 1053 (Fed. Cir. 1986), the taxpayer argued that an amount equal to the fair rental value of the land upon which the taxpayers operated their commercial ventures was directly derived from the land and should be exempt. In Cross v. Commissioner, 83 T.C. 561, 567-68 (1984) aff'd sub nom. Dillon v. United States, 792 F.2d 849 (9th Cir. 1986), the taxpayer argued that an amount equal to the fair rental value of the land upon which the petitioner's smokeshop was located should be exempt.

The Service's original position on allocation is set forth in Rev. Rul. 60-377, 1960-2 C.B. 13, allowing allocation of proceeds from the sale of cattle, horses, sheep and goats raised on allotted land. The income was allocated between exempt income attributable to the land, and non-exempt income attributable to labor and use of the equipment. However, this revenue ruling was revoked by Rev. Rul. 62-16, 1962-1 C.B. 7, which ruled that all of the proceeds were exempt. Currently the Service will allow a total exemption if income is primarily attributable to land factors. Id. In addition, the Service permitted an Indian to divide his income into exempt and nonexempt portions when the primary source of income is taxable, but the income directly derived from the land is from a separate business with separate books and records.

III. From which type of land must the arts and crafts be derived?

A. Allotment land. "Capoeman states that the General Allotment Act of 1887 exempts an Indian's income, derived directly from his or her allottted and restricted land, from income taxation. However, this rule applies only to Indians who hold allotted land under a trust patent and who may not alienate or encumber that land without the consent of the United States." Cook v. Commissioner, 32 Fed. Cl. 170, 173 (1994). In Rev. Rul. 67-284, the first requirement for exemption is that an allotment must be held in trust by the federal government. This requirement appears to exclude restrictive allotments from exemption. A restrictive allotment is one that cannot be alienated without federal consent but that is not held in trust by the federal government.

If an allotment meets the first and second requirements of Rev. Rul. 67-284, (held in trust and is subject to restrictions upon alienation) it is unlikely that the courts will deny an exemption for income directly derived from that land. Courts have concluded that the GAA tax-exemption can be read into the IRA even though the IRA itself does not contain express exemption language. Karmun v. Commissioner, 749 F. 2d 567, 570 (9th Cir. 1984) See also Rev. Rul. 74-13, 1974-1 C.B. 14 (tax exempt status of lands purchased under § 5 of the IRA) The authority for reading the tax exemption from the GAA into other allotment statutes was explained in Anderson v. United States, 845 F.2d 206, 208 (9th Cir. 1988), citing Stevens v. Commissioner, 452 F.2d 741, 744-45 (9th Cir. 1971): "Congress had made clear, by two legislative acts, that all future allotments would be subject to the terms of the General Allotment Act and would carry the same rights and privileges. In light of the "long-standing Congressional policy of treating Indians equally, except where differences in tribal circumstance justify special legislation," we concluded that those statutes indicated that Congress intended the terms of the General Allotment Act to apply to all allotments." See also Rev. Rul. 69-164, 1969-1 C.B. 220 (Quapay trust allotments not exempt by treaty or statute from direct taxation. Income derived from allotted Quapay lands not taxable because the Quapaws should be treated the same as any other tribe of Indians, citing United States v. Hallam, 304 F.2d 620 (10th Cir. 1962)).

Handbook of Federal Indian Law states that all allotments are tax exempt. "Several tribes were, however, specifically excepted from the General Allotment Act, and special allotment laws for them are not subject to it. In practice the only contested tax issues raised by these exceptions have concerned the Quapay and Osage allotment laws. Lower federal courts have determined that these laws have the same general purpose as the General Allotment Act and should imply the same tax status. These decisions concluded that the Supreme Court's essential holding in Capoeman depended on interpretation of the purpose of the General Allotment Act, rather than on the specific terms of sections 5 and 6. The I.R.S. has acquiesced in these decisions; it is thus settled law that all allotted lands are subject to the same tax exempt status as the Supreme Court recognized in Capoeman." F. Cohen, Handbook of Federal Indian Law, at 393-94.(1982) citing United States v. Hallam, 304 F.2d 620 (10th Cir. 1962).

B. Leased land. Income directly derived by a tribal member from leased land is not exempt when the leased land is owned by the tribe. Income derived by an Indian as lessee or permittee under a grazing permit obtained from the tribe is not derived directly from the land and is not exempt. Holt v. Commissioner, 364 F.2d 38, 41 (8th Cir. 1966), cert. denied, 386 U.S. 931 (1967); Rev. Rul. 58-320, 1958-1 C.B. 24. Nor is income directly derived from land leased from the owner of the allotment exempt to a tribal member lessee. United States v. Anderson, 625 F.2d 910, 913 (9th Cir. 1980); Rev. Rul. 57-523, 1957-2 C.B. 51; .

C. Fee simple land. Income derived from fee simple land owned by an individual tribal member is not tax exempt. See Holt v. Commissioner, 364 F.2d 38, 39-40 (8th Cir. 1966); Rev. Rul. 67-284, 1967-2 C.B. 55.

D. Possessory interest. In Critzer v. United States, 77-2 USTC ¶ 9540 Ct. Cl. Trial Div. (1977), rev'd on other grounds, 220 Cl. Ct. 43 (1979), the court considered whether a possessory interest was the equivalent of a trust allotment for purposes of the exemption under Capoeman. In Critzer, the government argued that income derived from possessory interests provided under the Cherokee Allotment Act of 1924, ch 253, 43 Stat. 376, 25 U.S.C. § 331 (note) (1988) was not exempt from income tax. The government contended that the Cherokee Allotment Act (CAA) does not provide an exemption from taxation and that a possessory interest is not the equivalent of a trust allotment because it is a permanent rather than a temporary interest. The court held that income directly derived from a possessory interest is exempt. The court explained that the CAA does provide an exemption. It further explained that subsequent to the enactment of the Indian Reorganization Act in 1934, a trust allotment is no longer a temporary interest, and, consequently, the chief difference between the two interests has disappeared.

E. Tribe B land. Tribe B land does not satisfy the five requirements of Rev. Rul. 67-284 because it is unallotted tribal land. Nevertheless, the Service has determined that income derived from these lands is exempt from income tax. "Absent a provision in a treaty or statute to the contrary, income directly derived by a member of an Indian tribe from unallocated Indian tribal lands is subject to federal income tax." Rev. Rul. 67-284. According to the Service, provisions of the Indian Allotment Act of 1905 applicable to Tribe B provide such an exception.

Summary: Income from allotted land that is held in trust for an individual Indian and cannot be alienated without the consent of the federal government will almost always be held by the courts to be exempt from federal income tax under Capoeman. Under Rev. Rul. 67-284, however, the Service also considers whether there is authority in a statute or treaty for the exemption with respect to income directly derived from that particular allotment land. Income derived from unallotted land owned by the tribe is not generally exempt under Capoeman, but may be exempt pursuant to a treaty or statute. Income derived from leased land, whether leased from the tribe or from the individual allotment owner, is not tax exempt to the lessee. Income derived from fee simple land owned by an individual Indian is not tax exempt.

IV Application to the present case.

Income from the sale of Indian arts and crafts is subject to federal income taxation unless the seller created the arts and crafts item from materials derived from their own allotted land and the value of such materials constitutes the major portion of

the selling price. Only in very unusual cases does the major portion of the selling price of Indian arts and crafts come from crops raised on the allotted land or animal products from animals raised on the allotted land. For example, the income from the sale of a doll would rarely be tax exempt because the primary source of the income from the sale of the doll is usually the equipment and labor rather than the value of the materials used to produce the doll. The income from the sale of Indian baskets and rugs is also rarely exempt from federal income taxation. The income from the sale of baskets is tax exempt if the reeds or grasses from which the basket is made grew on allotted land and the primary source of the income derived from the sale of the basket is the value of the reeds or grasses rather than the equipment and labor involved in producing the basket. The income from the sale of a wool rug would be tax exempt only if the wool is derived from sheep raised on the allotted land and the primary source of the income derived from the sale of the rug is the value of the wool rather than the equipment and labor involved in producing the rug. If the rug is made from wool from sheep not raised on the allotted land than the income from its sale is clearly not tax exempt.

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

Please contact Carol Cook at 622-6080, if you have questions.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

None.

Elizabeth A. Purcell, Chief, EO Branch 2
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Attachment:
Administrative file