

**STATE OF ARKANSAS
DEPARTMENT OF FINANCE & ADMINISTRATION
OFFICE OF HEARINGS & APPEALS**

ADMINISTRATIVE DECISION

IN THE MATTER OF

[REDACTED]

**WITHHOLDING
PASS-THROUGH
TAX ASSESSMENTS
(ACCT. NO.: [REDACTED])**

DOCKET NOS.: 19-437

**PERIOD ENDING: 12/31/15
(\$ [REDACTED])¹**

19-438

**PERIOD ENDING: 12/31/16
(\$ [REDACTED])²**

19-439

**PERIOD ENDING: 12/31/17
(\$ [REDACTED])³**

RAY HOWARD, ADMINISTRATIVE LAW JUDGE

APPEARANCES

This case is before the Office of Hearings and Appeals upon a written protest dated March 21, 2019, and submitted by [REDACTED], CPA, on behalf of [REDACTED], the Taxpayer. The Taxpayer protested assessments of Withholding Pass-through Tax resulting from an audit conducted by the Department of Finance and Administration (“Department”). The Letter ID Numbers are [REDACTED].

At the request of the Taxpayer, the matter was submitted for a decision based upon consideration of written documents. A Briefing Schedule was mailed to the representatives of the parties on May 8, 2019. The Department was

¹ The reflected amount includes tax (\$ [REDACTED]), penalty (\$ [REDACTED]), and interest (\$ [REDACTED]).

² The reflected amount includes tax (\$ [REDACTED]), penalty (\$ [REDACTED]), and interest (\$ [REDACTED]).

³ The reflected amount includes tax (\$ [REDACTED]), penalty (\$ [REDACTED]), and interest (\$ [REDACTED]).

represented by John Theis, Attorney at Law, Office of Revenue Legal Counsel. The Taxpayer was represented by [REDACTED], CPA. The Department's Opening Brief was filed on June 10, 2019. The Taxpayer's Protest Form and an attached letter were received into evidence. No other briefs were filed and the matter was submitted for a decision on July 29, 2019.

ISSUE

Whether the assessments made by the Department against the Taxpayer should be sustained? Yes.

FINDINGS OF FACT/CONTENTIONS OF THE PARTIES

A letter submitted with the Taxpayer's Protest provided, in pertinent part, as follows:

This letter is in response to the letter from the State of Arkansas Department of Finance and Administration dated January 3, 2019 sent to [REDACTED]. This letter confirms the status of [REDACTED] (" [REDACTED] ") for federal and state tax purposes.

The [REDACTED] is a federally-recognized Indian Tribe exempt from federal and state tax under Sections 115 and 7871 of the Internal Revenue Code of 1986, as amended. The [REDACTED] is a tribally chartered corporation. The Tribe owns 100% of the stock of the [REDACTED]. As such, [REDACTED] is an agency and instrumentality of the Tribe, and the [REDACTED] is thereby itself exempt from federal and state tax under Code Sections 115 and 7871.

Based upon the entity status outlined above, we believe that the tax liability stated in the letter for account [REDACTED] has been wrongfully assessed, and we would appreciate if you would update your records accordingly. [P. 1]

The Department's Opening Brief addressed the contentions in the letter submitted with the Taxpayer's Protest and stated, in part:

The Arkansas Department of Finance and Administration (DFA) issued Notices of Proposed Assessment dated January 2, 2019, against the [REDACTED] (Taxpayer) for Pass Through Entity Withholding Tax for the tax years 2015, 2016, and 2017. By letter to DFA dated January 11, 2019, [REDACTED], [REDACTED], objected to these assessments. That letter is treated as a timely protest of the Notices of Proposed Assessment and an administrative hearing on written documents was scheduled to consider that protest.

Taxpayer is a corporation chartered by and wholly owned by the [REDACTED], a sovereign tribal government recognized by the United States. It is DFA understanding that taxpayer operates as a Subchapter S corporation. Information received by DFA revealed that Taxpayer received income from partnerships in each of the tax years covered by the Notice of Proposed Assessment. For tax year 2015, that information reveals that Taxpayer received \$ [REDACTED] from [REDACTED]; \$ [REDACTED] in 2016 from [REDACTED]; and \$ [REDACTED] from [REDACTED]. The income in question was all earned from activities in Arkansas where Taxpayer's non-resident member has no tribal or reservation land.

DFA records indicate that the Taxpayer failed to withhold or pay Arkansas income tax on the share of its income from Arkansas sources that was distributed by Taxpayer to its nonresident member. Taxpayer contends that because the nonresident member is a federally recognized tribe, it is exempt from Arkansas income tax or withholding tax. DFA disagreed with this legal conclusion and issued the tax assessment in question. Additionally, the Taxpayer contends that, as a tribally chartered corporation, the Taxpayer is an agency and instrumentality of the Tribe and is exempt from both federal and state taxes under Sections 115 and 7871 of the Internal Revenue Code.

...

The language of Ark. Code Ann. § 26-51-919(b)(1)(A) above⁴ requires a pass-through entity to withhold Arkansas income tax at the highest income tax rate imposed by law on the share of its income derived from Arkansas sources and distributed to a nonresident member. If the entity is a lower-tier pass-through entity, Ark. Code Ann. § 26-51-919(b)(1)(B)(i) requires that entity to withhold and pay income tax on the share of the income distributed by the lower-tier pass-through entity to its nonresident members. Ark. Code Ann. § 26-51-919 (c)(4) provides an exemption from the

⁴ The quoted statutory language was omitted.

tax if the nonresident member is not subject to withholding and Ark. Code Ann. § 26-51-919(c)(6) provides an exemption if the income received by the nonresident member is exempt from tax. That fact that the non-resident member of the lower-tier pass-through entity is an Indian tribe does not entitle Taxpayer to either of these tax exemptions and does not preclude the assessment of tax derived from Taxpayer's business activities in Arkansas.

Research conducted by DFA reveals that state income taxes may be validly imposed on tribal activities in certain circumstances. State income taxes have been validly imposed on several occasions on tribal business activities conducted outside tribal Indian country. In the case of Mescalero Apache Tribe v. Jones, 411 U.S. 145 (1973), the U.S. Supreme Court considered a state gross receipts tax assessment on income derived by an Indian tribe from a ski resort operated off tribal lands. The Court quoted from several prior cases to the effect that:

Indians going beyond reservation boundaries have generally been held subject to nondiscriminatory state law otherwise applicable to all citizens of the State. (Internal cites omitted)

The Court ultimately sustained the New Mexico gross receipts tax stating:

In this context, we will not imply an expansive immunity from ordinary income taxes that businesses throughout the State are subject to.

The reasoning of the Mescalero case has been adhered to in several Court decisions, resulting in business activity occurring off tribal lands being subject to non-discriminatory state taxation. The income earned by Taxpayer arose from Taxpayer's investment in limited partnerships doing business in Arkansas. Taxpayer owns no tribal lands in Arkansas and partnership income is subject to a uniform, non-discriminatory tax in Arkansas. Consequently, the assessment of pass-through withholding tax against Taxpayer is proper under the law, notwithstanding the fact that Taxpayer is an instrumentality of an Indian tribe.

Additionally, publications from the U.S. Department of Interior entitled "Choosing a Tribal Business Structure" contains the following statement:

What are the major advantages of a tribally chartered corporation?

1) Avoidance of state regulation and taxation: A tribally chartered corporation **doing business on Indian land** whose stock is owned by Indians will not be subject to state control or taxation. However, if the tribally chartered corporation conducts business outside of the reservation, it should be aware that some states may require it to register with them as a “foreign corporation” as they do for all other out-of-state corporations operating within them. (Emphasis added)

The language bolded above indicates that any exemption from state taxation is available to the tribally chartered corporation is limited to income earned from activities on Indian land and does not extend income earned off Indian land. This conclusion is identical to information contained in a document issued by the Wisconsin Department of Revenue entitled “**Wisconsin Taxation Related to Native Americans**”.

The specific section of that publication that is of concern is found on page 8 (Copy attached) and states:

A tribe or Native American who engages in business activities shall be exempt from the Wisconsin corporate franchise or income tax on income derived from such business activities, if such activities are carried on only on the tribe’s or Native American’s tribal land.

If the tribe’s or Native American’s business activities are carried on both on and off the tribe’s or Native American’s tribal land, the tribe or Native American shall be taxed only on such income as is derived from business transacted and property located off the tribe’s or Native American’s tribal land in Wisconsin, unless federal preemption applies.

As demonstrated in the Mescalero decision above, the mere fact that the nonresident member of the pass-through entity is an Indian tribe does not shield the income from state taxation. Instead, a state income tax may be properly levied if the income is earned from income producing activities conducted outside Indian lands, is imposed on a nondiscriminatory basis, and the tax applies equally to all taxpayers in the state. The pass-through withholding tax imposed in this case satisfies all three tests. The income producing activity involves participation in investment partnerships conducting business in Arkansas, the [REDACTED] does not have any Indian land within Arkansas, the tax is equally applicable to all similarly situated taxpayers, and that tax applies to all citizens. In fact, Arkansas law allows the Taxpayer to avoid the obligation to pay the pass-through entity withholding tax if the

nonresident member participates in a composite tax return as provided in Ark. Code Ann. § 26-51-919(c). Also, resident members of the pass-through entity are subject to the same withholding tax requirements by the provisions of Ark. Code Ann. 26-51-911.

The Taxpayer contended that, as a tribally chartered corporation, the Taxpayer is an agency and instrumentality of the Tribe and is exempt from both federal and state taxes under Sections 115 and 7871 of the Internal Revenue Code. Sections 115 defines what is included in federal gross income. This section of federal law is not relevant for Arkansas tax purposes. Instead, Arkansas law contains a separate state law provision at Ark. Code Ann. § 26-51-404 defining the term “gross income” for state income tax purposes. This definition does not incorporate or rely on IRS Section 115. Section 7871 is a provision of federal income tax law providing that Indian Tribal governments or their subdivisions are treated as States for certain federal tax purposes. This provision of the federal income tax code is not relevant for state income tax purposes. [Footnote added, P. 1-6].

CONCLUSIONS OF LAW

Standard of Proof

Ark. Code Ann. § 26-18-313(c) (Supp. 2017) provides, in pertinent part, as follows:

The burden of proof applied to matters of fact and evidence, whether placed on the taxpayer or the state in controversies regarding the application of a state tax law shall be by preponderance of the evidence.

A preponderance of the evidence means the greater weight of the evidence.

Chandler v. Baker, 16 Ark. App. 253, 700 S.W.2d 378 (1985). In Edmisten v. Bull Shoals Landing, 2014 Ark. 89, at 12-13, 432 S.W.3d 25, 33, the Arkansas Supreme

Court explained:

A preponderance of the evidence is “not necessarily established by the greater number of witnesses testifying to a fact but by evidence that has the most convincing force; superior evidentiary weight that, though not sufficient to free the mind wholly from all reasonable doubt, is still sufficient to incline a fair and impartial mind to one side of the issue rather than the other.

The Department bears the burden of proving that the tax law applies to an item or service sought to be taxed, and a taxpayer bears the burden of proving entitlement to a tax exemption, deduction, or credit. Ark. Code Ann. § 26-18-313(d) (Supp. 2017). Statutes imposing a tax or providing a tax exemption, deduction, or credit must be reasonably and strictly construed in limitation of their application, giving the words their plain and ordinary meaning. Ark. Code Ann. § 26-18-313(a), (b), and (e) (Supp. 2017). If a well-founded doubt exists with respect to the application of a statute imposing a tax or providing a tax exemption, deduction, or credit, the doubt must be resolved against the application of the tax, exemption, deduction, or credit. Ark. Code Ann. § 26-18-313(f)(2) (Supp. 2017).

Withholding Pass-Through Tax Assessments

Pass-through entities are required to withhold income tax on a nonresident member's share of income that is attributable to sources within this state and distributed to the nonresident member unless an exemption applies. See Ark. Code Ann. § 26-51-919 (Repl. 2012)⁵ and Income Tax Rule 2006-3. The Taxpayer did not dispute the amounts of income received from partnerships during 2015, 2016, or 2017. The Conclusion Section of Department's Opening Brief stated that:

The information supplied by Taxpayer fails to prove that Taxpayer is exempt from the obligation to pay pass-through entity withholding tax. Instead, federal and state law clearly provide that an Indian tribe is not exempt from the payment of a state tax on income earned off Indian lands. This treatment is repeated in

⁵ The 2017 Supplement contains a version of Ark. Code Ann. § 26-51-919 which is applicable to tax years 2018 and thereafter.

publications issued by the U.S. Department of Interior and other state governments. [P. 6].

The authority cited in the Department's Opening Brief is persuasive and supports the Department's position in this matter. Since the Taxpayer does not have any tribal lands in the State of Arkansas, the Department correctly assessed Withholding Pass-through Tax against the Taxpayer.

Interest was properly assessed upon the tax deficiency for the use of the State's tax dollars. See Ark. Code Ann. § 26-18-508 (Repl. 2012). The penalty was properly assessed under Ark. Code Ann. § 26-18-208(1).


DECISION AND ORDER

The proposed assessments are sustained. The file is to be returned to the appropriate section of the Department for further proceedings in accordance with this Administrative Decision and applicable law. Pursuant to Ark. Code Ann. § 26-18-405 (Supp. 2017), unless the Taxpayer requests in writing within twenty (20) days of the mailing of this decision that the Commissioner of Revenues revise the decision of the Administrative Law Judge, this Administrative Decision shall be effective and become the action of the agency. The revision request may be mailed to the Assistant Commissioner of Revenues, P.O. Box 1272, Rm. 2440, Little Rock, Arkansas 72203. A revision request may also be faxed to the Assistant Commissioner of Revenues at (501) 683-1161 or emailed to revision@dfa.arkansas.gov. The Commissioner of Revenues, within twenty (20) days of the mailing of this Administrative Decision, may revise the decision regardless of whether the Taxpayer has requested a revision.

Ark. Code Ann. § 26-18-406 (Supp. 2017) provides for the judicial appeal of a final decision of an Administrative Law Judge or the Commissioner of

Revenues on a final assessment or refund claim denial; however, the constitutionality of that code section is uncertain.⁶

OFFICE OF HEARINGS & APPEALS



RAY HOWARD
ADMINISTRATIVE LAW JUDGE

DATED: July 31, 2019

⁶ See Board of Trustees of Univ. of Arkansas v. Andrews, 2018 Ark. 12.