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7 **BOARD OF EQUALIZATION**  
8 **STATE OF CALIFORNIA**

10 In the Matter of the Appeal of: ) **HEARING SUMMARY**  
11 ) **PERSONAL INCOME TAX APPEAL**  
12 **ROBERT C. JOHNSON** ) Case No. 574843  
13 **AND RUBY B. JOHNSON**<sup>1</sup> )

	<u>Year</u>	<u>Proposed Assessment</u>
	2007	\$1,012

18 Representing the Parties:

19 For Appellants: E. Scott Tidwell, TAAP<sup>2</sup>  
20 For Franchise Tax Board: Natasha Sherwood Page, Tax Counsel III

22 **QUESTION:** Whether California may tax appellant-wife's wage income received from a non-tribal  
23 employer located on her tribe's reservation while she resided on the reservation.

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26 <sup>1</sup> Appellants reside in Winterhaven, Imperial County, California.

27 <sup>2</sup> Appellants filed their own Appeal Letter. Subsequent representation has been provided by the Tax Appeals Assistance  
28 Program (TAAP), including the Reply Brief submitted by Camille Edwards and the Additional Brief submitted by E. Scott Tidwell.

1 HEARING SUMMARY

2 Background

3 Appellants live on the Quechan Indian Tribe's (the Tribe's) reservation in Winterhaven,  
4 California, near the Arizona border. Appellant-wife is a member of the Tribe and works at the Fort  
5 Yuma Indian Hospital, which is on the reservation and run by the federal Department of Health and  
6 Human Services, Public Health Service, Indian Health Service (DHHS), out of Tucson, Arizona.<sup>3</sup>  
7 Appellant-wife earned \$32,091 from DHHS in 2007. (Resp. Op. Br., p. 1.)

8 On appellants' 2007 California tax return, they reduced their California taxable income  
9 by appellant-wife's income of \$32,091 on their Schedule CA, claiming such income to be exempt from  
10 California income tax with the notation of "Legal Ruling #399" in the margin.<sup>4</sup> In a Notice of Proposed  
11 Assessment dated April 28, 2010, respondent initially challenged appellants' exclusion of appellant-  
12 wife's income and appellants' exclusion of \$1,513 in gambling winnings. Respondent eventually  
13 conceded the exclusion of the gambling winnings as such winnings came from the Tribe. After audit  
14 and protest, respondent determined that appellant-wife's wages were not earned from the Tribe and were  
15 therefore subject to California taxation. (Resp. Op. Br., p. 1.) On May 19, 2011, respondent issued a  
16 Notice of Action confirming this finding, increasing appellants' income by \$32,091 to taxable income of  
17 \$55,040 (i.e., \$22,949 taxable income originally reported + \$32,091 adjustment), resulting in \$1,102 of  
18 additional tax. (*Id.* at exhibit A.) This timely appeal followed.

19 Contentions

20 Appellants' Contentions

21 Appellants assert that appellant-wife's income from the Fort Yuma Hospital is exempt  
22 from California taxation under the *McClanahan* rule because she is a member of the Tribe, lives on the  
23 Tribe's reservation, and works on the reservation. (App. Reply Br., pp. 2, 4; *McClanahan v. Arizona*  
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25 \_\_\_\_\_  
26 <sup>3</sup> The Department of Health and Human Services is comprised of eleven agencies, known as Operating Divisions, and sixteen  
27 staff divisions. The Indian Health Service (IHS) is one of these eleven Operating Divisions, and is also a component of the  
28 United States Public Health Service. (U.S. Dept. of Health and Human Services, *Organizational Chart*  
<<http://www.hhs.gov/about/orgchart/>> [as of May 22, 2012].) For purposes of this appeal, the actions of IHS and its parent  
organizations will collectively be referred to as actions of DHHS.

<sup>4</sup> Respondent does not provide a copy of appellants' 2007 tax return, but provides this information. Respondent also notes  
that Legal Ruling #399 was withdrawn in 1998 pursuant to Legal Ruling 98-6. (Resp. Op. Br., p. 1.)

1 *State Tax Commission* (1972) 411 U.S. 164 [*McClanahan*].) Appellants contend that she meets the  
2 three-part test under *McClanahan* despite the fact that her employer is a federal government entity.  
3 Appellants assert that the *McClanahan* requirement of working “on the reservation” refers to the  
4 geographic locality of the taxpayer’s employment, and California has no jurisdiction to reach income  
5 generated on the reservation. (App. Reply Br., p. 3, citing *McClanahan* at p. 181.) Appellants state that  
6 appellant-wife’s employer serves “American Indians from the Quechan and Cocopah Indian  
7 Reservations.” (App. Add’l Br., p. 2 & Exhibit D.)

8 Appellants cite a Utah Supreme Court decision, *Maryboy*, in which a taxpayer’s income  
9 earned from a federally-funded hospital located on a reservation was exempt from taxation.<sup>5</sup> (App.  
10 Reply Br., p. 3; *Maryboy v. Utah State Tax Com.* (Utah Supreme Ct. 1995) 904 P.2d 662, 668-70  
11 [*Maryboy*].) Appellants contend that the United States Supreme Court has never stated that taxpayers  
12 must earn income from the reservation to meet the *McClanahan* requirements, and assert that the court  
13 opinion in *Maryboy* revealed that the taxpayer in *McClanahan* worked for an on-reservation branch of  
14 an off-reservation, non-tribal bank.<sup>6</sup> (App. Reply Br., pp. 3-4; citing *Maryboy* at p. 669, fn. 2.)  
15 Appellants contend that the requirement that income be from reservation sources only refers to the  
16 geographic location of the employer, stating that the “situs of the activity is the primary factor in  
17 determining whether state taxation jurisdiction exists...”<sup>7</sup> (App. Add’l Br., pp. 2, 4, citing *Angelina*  
18 *Mike v. Franchise Tax Board* (2010) 182 Cal.App.4th 817, 824 [*Angelina Mike*].)

19 Appellants contend that no cases on point narrow the reservation source income prong of  
20 the *McClanahan* test to apply only to tribal sources. (App. Add’l Br., p. 5.) Appellants assert that cases  
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22 <sup>5</sup> Appellants state that they cite to *Maryboy* to help clarify *McClanahan*, because the facts of each case are so similar.  
23 Appellants assert they did not cite to *Maryboy* in this appeal as binding precedent. (App. Add’l Br., p. 5, fn. 2.)

24 <sup>6</sup> The decision in *Maryboy* stated in footnote 2: “Although the Court in *McClanahan* did not state the nature of  
25 *McClanahan*’s employment, counsel at oral argument asserted that she [*McClanahan*] worked at the on-reservation branch of  
an off-reservation, nontribal bank.” (*Maryboy* at p. 669, fn. 2.)

26 <sup>7</sup> Appeals Division staff notes that this quote taken from *Angelina Mike* is borrowed from *La Roque v. State* (Mont. 1978) 178  
27 Mont. 315, a Montana Supreme Court case that was superseded by *Angelina Mike*. The Montana court was determining the  
28 issue of whether an Indian need be a member of the tribe upon whose reservation he or she resided in order to attain tax  
exempt status under *McClanahan*. The Montana court stated that the determining factors were situs (i.e., reservation) and  
status (i.e., Indian) to assert that tribal affiliation was not a deciding factor. In *La Roque*, the court used “situs” to refer to the  
location where the taxpayer resided, not the location from which income was received. (*La Roque, supra*, at pp. 324-325.)

1 from other jurisdictions show that courts only look to whether the income-generating activity takes place  
2 on the reservation or not, regardless of whether the income is earned from state, federal, tribal, or other  
3 sources.<sup>8</sup> (*Id.* at pp. 5-6, citing *Topash v. Commissioner of Revenue* (Minn. 1980) 291 N.W.2d 679  
4 [*Topash*] and *Fox v. Bureau of Revenue* (N.M. 1975) 87 N.M. 261 [*Fox*].)<sup>9</sup> Appellants assert that they  
5 are not asking the Board to hold any law unconstitutional, only that it apply the federal law as  
6 established by *McClanahan* and confirmed by the *Appeal of Arviso*, 82-SBE-108, June 29, 1982.<sup>10</sup>  
7 (App. Reply Br., p. 4.) Appellants assert that the Board has upheld the ruling in *McClanahan* in  
8 previous non-precedential decisions and likewise should do so here. (App. Add'l Br., p. 7.)

### 9 Respondent's Contentions

10 Respondent asserts that appellant-wife's income earned from DHHS is not earned from  
11 the Tribe, and therefore is not reservation-sourced for purposes of the *McClanahan* exemption.  
12 Respondent contends that while "reservation sources" may arguably be a reference to geography, it is  
13 more likely a reference to the Tribe and its jurisdiction. (Resp. Op. Br., p. 3.) Respondent asserts that  
14 appellants improperly rely on case law that is nonbinding in California. (Resp. Reply Br., pp. 2-3.)  
15 Respondent asserts that *Maryboy* is a Utah state court decision, and there is no authority to indicate that  
16 California courts would follow the reasoning set forth in the *Maryboy* decision. Respondent contends  
17 that the decision in *Maryboy* is also completely unique to the facts and Utah's state interests.  
18 Respondent also indicates that while the Utah court decided that the State of Utah did not have a  
19 sufficient interest in taxing Ms. Maryboy's income since her employment was very similar to many  
20 rank-and-file State employees, the court found that Utah had a great interest in taxing the income of  
21 Mr. Maryboy, an elected official. (*Ibid.*)

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24 <sup>8</sup> Appellants indicate that the cases cited from Minnesota and New Mexico, like *Maryboy*, are nonbinding in California, but  
contend that the cases are persuasive. (App. Add'l Br., p. 5.)

25 <sup>9</sup> Appellants note that these cases were overruled, but contend they were specifically only overruled because the Indian  
26 residents at issue did not live within their tribal lands, and not because their income was earned from a federal agency. (App.  
Add'l Br., p. 5.)

27 <sup>10</sup> The *Appeal of Arviso*, *supra*, relied upon *McClanahan* to reach its conclusion. The Board in that decision, however,  
28 discussed whether Indians must live on a reservation in order to be considered "reservation Indians" under the *McClanahan*  
rule. The Board did not discuss income source or even mention the employer of the taxpayers in the *Appeal of Arviso*, *supra*.

1 Respondent contends that the Board has expressed its belief that Article III, section 3.5,  
2 of the California Constitution precludes a finding that R&TC section 17041 is unenforceable pursuant to  
3 federal preemption unless an appellate court has made such a determination. (Resp. Op. Br., pp. 3-4.)  
4 Respondent asserts that there is no clear authority advising respondent that appellant-wife's income is  
5 exempt from taxation under R&TC section 17041. (Resp. Reply Br., p. 3.) Respondent states that  
6 *Maryboy* is not binding law in California, but is a good example for showing how complicated a  
7 preemption analysis can be, and how such analysis can result in one spouse's non-tribal income being  
8 taxable while another spouse's non-tribal income is not taxable. Respondent asserts that there is no  
9 decisional case law in California on this issue and no telling how a California court might rule on the  
10 facts of this case. (*Ibid.*) Therefore, respondent contends the Board should deny the appeal based on the  
11 abstention doctrine. (Resp. Op. Br., p. 5.)

#### 12 Applicable Law

##### 13 Proposed Assessment of Tax

14 California imposes tax on a resident's entire income from all sources. (Rev. & Tax.  
15 Code, § 17041, subd. (a).) A California "resident" includes "every individual who is in this state for  
16 other than a temporary or transitory purpose." (Rev. & Tax. Code, § 17014, subd. (a)(1).) The United  
17 States Supreme Court has stated that:

18 State sovereignty does not end at a reservation's border. Though tribes are often referred  
19 to as sovereign entities, it was long ago that the Court departed from Chief Justice  
20 Marshall's view that the laws of [a State] can have no force within reservation  
boundaries. Ordinarily, it is now clear, an Indian reservation is considered part of the  
territory of the State.

21 (*Nevada v. Hicks* (2001) 533 U.S. 353, 361-362 [internal quotes and cites omitted].) In other words, an  
22 individual does not cease to be a California resident merely by living on an Indian reservation that is  
23 within California's boundaries. Against this backdrop, California law purports to tax the entire income  
24 of any person who resides on an Indian reservation that is within California's borders. It is axiomatic,  
25 however, that California cannot confer upon itself the ability to tax income in violation of the United  
26 States Constitution or federal law.

27 The United States Congress has plenary and exclusive powers over Indian affairs.  
28 (*Washington v. Confederated Bands and Tribes of Yakima Indian Nation* (1979) 439 U.S. 463, 470-

1 471.) Throughout the history of our nation, Congress generally has permitted Indians to govern  
2 themselves, free from state interference. (*Warren Trading Post Co. v. Arizona Tax Comm'n* (1965) 380  
3 U.S. 685, 686-687.) States may exercise jurisdiction within Indian reservations only when expressly  
4 allowed to do so by Congress. (*McClanahan* at pp. 170-171.) Looking to the exclusive authority of  
5 Congress and traditional Indian sovereignty, the *McClanahan* Court created a three-part test when it  
6 held that a state may not impose personal income tax on (1) an Indian, (2) who lives on his own  
7 reservation, and (3) whose income derives from reservation sources. (*Id.* at pp. 173-178.) *McClanahan*  
8 has become the seminal case in this area; approximately 30 years ago, the Board asserted that the  
9 taxation question turns on whether an appellant is a “reservation Indian” within the meaning of  
10 *McClanahan*. (See *Appeal of Edward T. and Pamela A. Arviso*, 82-SBE-108, June 29, 1982.) It is  
11 settled law that a state may tax all of the income, including reservation-source income, of an Indian  
12 residing within the state and outside of his own tribe’s Indian country.<sup>11</sup> (*Oklahoma Tax Commission v.*  
13 *Chickasaw Nation* (1995) 515 U.S. 450; *Appeal of Edward T. and Pamela A. Arviso, supra*; *Angelina*  
14 *Mike, supra*.)

15 In the *Appeal of Samuel L. Flores* (2001-SBE-004), decided on June 21, 2001, the Board  
16 addressed the nature of per capita gaming distributions. The Board rejected the argument that an Indian  
17 tribe is like a partnership and instead concluded that a tribe is like a corporation. The Board held that  
18 per capita distributions from a tribe are income from an intangible sourced to the residence of the tribal  
19 member. The Board elaborated by stating that if the per capita distributions were received by a tribal  
20 member residing in California, but not on the reservation, it is taxable by California. Once respondent  
21 has met its initial burden of showing that its assessment is reasonable and rational, the assessment is  
22 presumed correct and appellant has the burden of proving that the assessment is wrong. (*Todd v.*  
23 *McColgan* (1949) 89 Cal.App.2d 509; *Appeal of Michael E. Myers*, 2001-SBE-001, May 31, 2001.)

24 In *Maryboy*, the Utah Supreme Court discussed the state’s right to impose income tax on  
25 a married couple who were Indians, who lived and worked on their own tribe’s reservation, and who  
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27 <sup>11</sup> The Supreme Court later stated that *McClanahan* created a presumption against state taxing authority which extends  
28 beyond the formal boundaries of the reservation, to “Indian country.” (*Oklahoma Tax Commission v. Sac & Fox Nation*  
(1993) 508 U.S. 114.) Congress defined “Indian country” to include reservations, dependent Indian Communities and Indian  
allotments. (*Ibid*; 18 U.S.C. 1151.)

1 were employed by entities other than the tribe. The wife was an employee of the Utah Department of  
2 Human Services (i.e., state government), while the husband was a local county commissioner (i.e., an  
3 elected official). After discussing numerous federal cases, including *McClanahan*, the Utah Supreme  
4 Court concluded that Utah's income tax was preempted with regard to the wife, but not with regard to  
5 the husband. While the state's interests in the wife's employment were no more than any private  
6 employer with an employee performing similar duties, the state had a compelling interest in the  
7 husband's employment as an elected official. The Court found that distinction sufficient to support a  
8 state interest in taxing the husband's income, but not the wife's. (*Maryboy, supra*, at pp. 669-670.)

### 9 Federal Preemption

10 Section 3.5 of article III of the California Constitution states:

11 An administrative agency, including an administrative agency created by the Constitution  
12 or an initiative statute, has no power (a) [t]o declare a statute unenforceable, or refuse to  
13 enforce a statute, on the basis of it being unconstitutional unless an appellate court has  
14 made a determination that such statute is unconstitutional; (b) [t]o declare a statute  
15 unconstitutional; (c) [t]o declare a statute unenforceable, or to refuse to enforce a statute  
16 on the basis that federal law or federal regulations prohibit the enforcement of such  
17 statute unless an appellate court has made a determination that the enforcement of such  
18 statute is prohibited by federal law or federal regulations.

16 (See also Cal. Code Regs., tit. 18, § 5412, subd. (b).) In addition, the Board has a long-established  
17 policy of declining to consider constitutional issues. In the *Appeal of Aimor Corporation* (83-SBE-221),  
18 decided on October 26, 1983, the Board stated:

19 This policy is based upon the absence of any specific statutory authority which would  
20 allow the Franchise Tax Board to obtain judicial review of a decision in such cases and  
21 upon our belief that judicial review should be available for questions of constitutional  
22 importance. Since we cannot decide the remaining issues raised by appellant,  
23 respondent's action in this matter must be sustained.

22 This policy was in place long before the enactment of article III, section 3.5. As far back as 1930, the  
23 Board stated:

24 It is true that we have occasionally asserted that right [to question the constitutionality of  
25 a statute]. But this has been only under circumstances wherein such action on our part  
26 was necessary in order to protect the revenues of the state and get the problem before the  
27 Courts . . . . In the instant case, and in all others like it before us, the taxpayers will have  
28 the opportunity of taking the question to the Courts for decision. . . . It might be argued  
that, if the law is plainly unconstitutional, why should taxpayers be put to that trouble and  
expense? However, there is diversity of opinion as to the constitutionality of the Act, and  
it seems to us desirable that this controversy should be settled by the Courts, whose  
authority to hold acts of the Legislature invalid cannot be questioned.

1 (*Appeal of Vortex Manufacturing Co.*, 30-SBE-017, Aug. 8, 1930 [internal citations omitted].)

2 STAFF COMMENTS

3 Both parties concede that appellant-wife was a member of the Tribe, lived on the Tribe's  
4 reservation, and received \$32,091 from her federal employer, DHHS. The parties agree that appellant-  
5 wife met the first two parts of the *McClanahan* test, since she lived on her own tribe's reservation, but  
6 disagree as to whether her income was derived from reservation sources. Appellants contend that the  
7 requirement was met, because appellant-wife worked within the boundaries of the reservation.  
8 Respondent contends that the requirement was not met, because appellant-wife did not receive the  
9 income from tribal sources. The determining factor is whether the phrase "reservation sources" refers to  
10 tribal sources or to any income-earning activities carried on within the boundaries of the reservation.

11 Appellants cite to *Maryboy*, *Topash*, and *Fox*, all state-level decisions from other  
12 jurisdictions that appellants concede are nonbinding law, but contend should be persuasive. In *Maryboy*,  
13 the Utah Supreme Court used a weighing method to determine the state's interest in the occupational  
14 duties of two taxpayers. The court found that taxing Mr. Maryboy did not interfere with tribal self-  
15 governance, noting, among other things, that his duties as an elected county commissioner gave his work  
16 county-wide effect that extended beyond the reservation and that his income was not derived from  
17 "value generated on the reservation." (*Maryboy* at p. 669, citing *Wash. v. Confederated Tribes of*  
18 *Colville Indian Reservation* (1980) 447 U.S. 134 [*Colville*].) Conversely, the court found that  
19 Ms. Maryboy's position as a therapist at a state-run health center on the reservation depended entirely on  
20 the need or desire of the Reservation Navajos for mental health services, and therefore the value was  
21 derived from on-reservation conduct involving only tribal members. The court determined that the state  
22 had an interest in the work performed by Ms. Maryboy, but that interest did not outweigh the interest of  
23 the Navajo tribe so as to overcome the presumption created by *McClanahan*, such that Ms. Maryboy's  
24 income was not taxable by the state. (*Id.* at pp. 668-669.) This case presents facts that are similar to the  
25 present appeal, but still distinct, and provides an analysis unique to the law of Utah and that state's  
26 interests. This court case is not binding on California, and is not bound by similar restrictions that affect

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1 the Board's ability to determine constitutional issues.<sup>12</sup>

2 Appellants also cite to *Topash*, a Minnesota Supreme Court case, and *Fox*, a New Mexico  
3 Supreme Court case. These cases both involve a tribal member living on another tribe's reservation and  
4 working for the United States Bureau of Indian Affairs, a federal employer.<sup>13</sup> Both taxpayers were  
5 originally granted tax exemption, but these decisions were later overruled by subsequent state Supreme  
6 Court decisions on the basis that the taxpayers in each case lived on reservation land that did not belong  
7 to their respective tribes. Neither decision provides a detailed examination of whether income can only  
8 be exempt if it is received from tribal sources, but inherently appear to have accepted income that was  
9 received from federal sources. Regardless, both decisions have been overruled, are nonbinding in  
10 California, and contain facts that vary from the facts in this appeal. These cases, as well as *Maryboy*, are  
11 indicative of the direction a few states are taking in deciding the issue presented in this appeal, but while  
12 these cases may be considered as persuasive, the cases fail to show a predominate acceptance of non-  
13 tribal-sourced income as being exempt under the derivation portion of the *McClanahan* test. The cases  
14 presented have either been overruled for other reasons or split on the issue. These decisions were also  
15 made at the highest state court level, where there are fewer restrictions on ruling on federal preemption  
16 issues than there are at the California administrative body level.

17 Precedential opinions, including United States Supreme Court and California Appellate  
18 Court decisions similarly fail to provide clear guidance on this issue. When describing the income  
19 received in *McClanahan*, the U.S. Supreme Court uses the terms "income derived wholly from  
20 reservation sources," "income . . . derived from within the Navajo Reservation," "income earned  
21 exclusively on the reservation," and "Indians earning their income on the reservation." The U.S.  
22 Supreme Court in *Mescalero* uses the terms "Indian income from activities carried on within the  
23 boundaries of the reservation" (in contrast to activities carried on outside the reservation), and in  
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26 <sup>12</sup> As discussed above, the Board is bound by the California Constitution from deciding federal preemption issues without an  
27 appellate-level decision. The Utah Supreme Court has no such restrictions. The Utah Constitution states explicitly that, "The  
[Supreme] court shall not declare any law unconstitutional under this constitution or the Constitution of the United States,  
except on the concurrence of a majority of all justices of the Supreme Court." (UT Const., art. VIII, § 2.)

28 <sup>13</sup> While the court in *Topash* specifically states that the taxpayer worked for the Bureau of Indian Affairs, the court in *Fox*  
does not explicitly state the employer of the taxpayer, and merely states that she worked only on the Navajo Reservation.  
(*Fox*, at p. 261.) *Angelina Mike*, at page 824, states that the taxpayer in *Fox* was employed by the Bureau of Indian Affairs.

1 *Colville* used “reservation lands or income derived therefrom,” “receipts derived by reservation Indians  
2 from reservation sources,” “income derived solely from reservation sources,” and “reservation-derived  
3 income.” The California Court of Appeal in *Angelina Mike* used the terms “income earned exclusively  
4 on the reservation,” “income . . . derived from their own tribe’s lands,” “income [sourced] from ‘Indian  
5 Lands’,” and “income from reservation activities.” Appeals Division staff notes that, while most of the  
6 terms and phrases used in these examples appear to be vague, none of these cases dealt with the issue in  
7 this appeal, and focused on other issues such as whether the income was earned off the taxpayer’s own  
8 tribe’s reservation.

9           Based on the relevant case law, and the ambiguity of the language used therein, it appears  
10 as though this issue has not yet been clearly decided. The parties similarly provide evidence that the  
11 issue is still undecided. Respondent asserts that the definition of reservation-sourced income “is more  
12 than likely a reference to the Tribe and its jurisdiction,” and appellants provide nonbinding law and the  
13 concept that the lack of an explicit requirement that the income must be tribal-sourced to support their  
14 argument. It appears as though this matter “falls in an interstice of decisional law.” (*Angelina Mike* at  
15 p. 819.) Based on the lack of clear appellate-level authority to apply federal preemption when a tribal  
16 member on her own reservation receives income from non-tribal sources located on the reservation, the  
17 Board may want to consider a denial of the appeal based on the policy of abstention.

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