ARIZONA TAX COURT

TX 2004-000182 04/14/2006

HONORABLE MARK W. ARMSTRONG

CLERK OF THE COURT
L. Slaughter
Deputy

FILED: _____

LEISURE DEVELOPMENT, INC.

GERALD W. NABOURS
ATTORNEY AT LAW
10 E. DALE AVENUE
FLAGSTAFF, AZ 86001

v.

CITY OF FLAGSTAFF

ERIN E. BYRNES
ANGELA KIRCHER
MANGUM, WALL, STOOPS & WARDEN
100 N. ELDEN ST.
FLAGSTAFF, AZ 86002

UNDER ADVISEMENT RULING

This matter was taken under advisement after Oral Argument on February 23, 2006, on Defendant's Motion for Summary Judgment. The Court has considered the papers and arguments of the parties.

I. THE ISSUES

The Court must address two issues in this case. First, whether the transaction privilege tax that the City of Flagstaff ("City") has imposed on Leisure Development Inc.'s ("Leisure Development") sales of manufactured homes to Native Americans is constitutional. Second, whether the City's use of sampling during its audit of Leisure Development was an appropriate method to establish unreported income.

II. FACTUAL BACKGROUND

Leisure Development is a dealer of manufactured homes. Its only sales lot, until its closure in 2003, was located within Flagstaff city limits. Leisure Development's solicitation of sales included radio and print advertising on the Navajo and Hopi Reservations. All contracts involving sales of new manufactured homes to Native American customers were signed at

Leisure Development's Flagstaff office. Leisure Development determined whether a sale was to a Native American, and therefore allegedly exempt from Flagstaff's transaction privilege tax, based upon the appearance of the customer, where the customer was from, and where the house was to be delivered.

Flagstaff City Tax Code § 3-5-400 levies a transaction privilege tax on all business transactions conducted within city limits. The code section specifically applicable to manufactured buildings provides that "such business activity is deemed to occur at the business location of the seller where the purchaser first entered into the contract to purchase the manufactured building." Flagstaff City Tax Code § 3-5-427. However, an exemption in the City Tax Code's implementing regulations provides:

> Sales to Native Americans … by vendors located within the City shall be deemed sales within the City, unless all of the following conditions exist:
> (1) The vendor has properly accounted for such sales, in a manner similar to the recordkeeping requirements for out-of-City sales; and,
> (2) All of the following elements of the sale exist:
> A. solicitation and placement of the order occurs on the reservation; and
> B. delivery is made to the reservation; and
> C. payment originates from the reservation.

Reg. 3-5-100.4.

Around April 1, 2002, one of the City's sales tax auditors, Wanda Uranich, became aware that Leisure Development did not treat as taxable any transactions involving persons it believed to be Native American. Based on this information, the City instituted an audit of Leisure Development. On October 11, 2002, Ms. Uranich sent a letter to Leisure Development indicating that the audit would be conducted using the sampling method and identifying the months to be audited. Leisure Development did not object at that time to either the use of sampling or to the months selected.

When Ms. Uranich began the audit on November 11, 2002, Leisure Development was unable to provide any income records for the sample months in 1998, 1999, and January through August of 2000. As a result, Ms. Uranich reviewed Leisure Development's customer contracts for those months in order to identify the difference between Leisure Development's reported taxable income and its gross income. For the sample months in 2001 and 2002, Leisure Development was able to provide income records from which Ms. Uranich could compare taxable income and gross income. After reviewing all of the relevant documents, Ms. Uranich calculated an error rate of approximately 42% for the period August 1998 through June 2001, and an error rate of approximately 56% for the period July 2001 through July 2002. Based on the audit, Leisure Development was assessed a total tax of $59,669.33, including penalties and interest.

Subsequently, Leisure Development filed a protest letter and the matter was referred to a Municipal Tax Hearing Officer. On September 8, 2003, the Hearing Officer issued his ruling that: (1) the City was entitled to levy a transaction privilege tax on the transactions involving Native Americans; (2) both Flagstaff City Tax Code § 3-5-427 and Regulation 3-5-100.4 were lawful; (3) Leisure Development failed to maintain adequate records to substantiate deductions taken for sales to Native Americans, as required by Regulation 3-5-350.1; and (4) because Leisure Development had failed to raise the issue of the use of sampling at the hearing or during the audit, the City's use of sampling should be approved.

III. THE COURT'S FINDINGS AND CONCLUSIONS

A. CONSTITUTIONALITY OF THE CITY'S IMPOSITION OF ITS TRANSACTION PRIVILEGE TAX ON LEISURE DEVELOPMENT'S SALES TO NATIVE AMERICANS

As applied to the facts in this case, the Court finds that the City's imposition of its transaction privilege tax on Leisure Development's sales of manufactured homes to Native Americans is constitutional because the transactions occurred off-reservation.

In 1790, the first Congress of the United States passed a statute "to regulate trade and intercourse with the Indian tribes" by requiring Indian traders to obtain a license from a federal official. Act of July 22, 1790, 1 Stat. 137. Since that time, Congress has comprehensively regulated trade with Native Americans for the fundamental purpose of "ensuring that no burden shall be imposed upon Indian traders for trading with Indians on reservations except as authorized by Acts of Congress" in order to "protect Indians against prices deemed unfair or unreasonable." *Warren Trading Post Co. v. Ariz. State Tax Comm'n*, 380 U.S. 685, 691, 85 S.Ct. 1242, 1246 (1965). In *Warren Trading Post*, the Supreme Court held that the state of Arizona did not have the right to tax sales by a federally licensed retail trading business located on the Navajo Reservation to Native Americans. *Id.* at 686, 85 S.Ct. at 1243. The Court reasoned that by enacting the Indian trader statutes, 25 U.S.C. §§ 261-264, "Congress has taken the business of Indian trading *on reservations* so fully in hand that no room remains for state laws imposing additional burdens upon traders." *Id.* at 690, 85 S.Ct. at 1245 (emphasis added). In *Central Machinery Co. v. Arizona State Tax Commission*, 448 U.S. 160, 165, 100 S.Ct. 2592, 2596 (1980), the Supreme Court expanded its holding in *Warren Trading Post* by stating that "it is the existence of the Indian trader statutes … and not their administration, that pre-empts the field of transactions with Indians occurring *on reservations*." (Emphasis added). Thus, when a transaction occurs on-reservation, whether or not the seller is a licensed Indian trader, it is within the field of transactions the Indian trader statutes meant to protect.

Therefore, the initial question in this Court's analysis is whether Leisure Development's sales to Native Americans occurred on-reservation or off-reservation. "Absent express federal law to the contrary, Indians going beyond reservation boundaries have generally been held subject to non-discriminatory state law." *Mescalero Apache Tribe v. Jones*, 411 U.S. 145, 148,

93 S.Ct. 1267, 1270 (1973). In *Central Machinery*, the Supreme Court held that Arizona had no jurisdiction to impose a transaction privilege tax on the sale of tractors to a Native American tribe where the sale was solicited on the reservation, the contract was made on the reservation, and payment for and delivery of the tractors took place on the reservation. 448 U.S. 160, 100 S.Ct. 2592 (1980). The Court used the four factors of solicitation, contract, delivery, and payment to reason that the transaction was clearly on-reservation and, thus, within the field meant to be protected by the Indian trader statutes.

These are the same four factors required by the City, in Regulation 3-5-100.4, for a transaction to be considered on-reservation. However, the Supreme Court in *Central Machinery* did not intend those four factors to be a bright-line rule for determining whether a transaction is on-reservation. Rather, the Court used those factors to show that that specific transaction was within the field of transactions Congress meant to protect with the Indian trader statutes. Nonetheless, the facts in this case make it clear that Leisure Development's sales of manufactured homes occurred off-reservation and are not within the field of transactions Congress meant to protect by the Indian trader statutes. The Native Americans involved in these sales left the reservation, drove over 20 miles to Leisure Development's sales lot in Flagstaff, and once there, examined the product and negotiated the sales contract.

Even if, according to these facts, the sales were determined to have occurred on the reservation, the Court would still find that the City's imposition of its transaction privilege tax was constitutional. When a court determines a transaction occurs on-reservation, the next question it must ask is who bears the "legal incidence" of the tax. *See Okla. Tax Comm'n v. Chickasaw Nation*, 515 U.S. 450, 458, 115 S.Ct. 2214, 2220 (1995) ("The initial and frequently dispositive question in Indian tax cases … is who bears the legal incidence of a tax."). The Supreme Court in *Chickasaw Nation* determined that the focus is on the "legal incidence" of the tax, and not the "economic reality" of whether the cost is passed on. *Id.* at 459, 115 S.Ct. at 2221. Although legal incidence can be easily manipulated by the states, it provides a bright-line test that accommodates the predictability required for tax administration. *Id.* at 460, 115 S.Ct. at 2221. If a transaction occurs on-reservation and the legal incidence of the tax rests on Native Americans, then the tax is preempted by federal law and is unenforceable. *See Chickasaw Nation*, 515 U.S. at 459, 115 S.Ct. at 2220; *Wagnon v. Prairie Band Potawatomi Nation*, 126 S.Ct. 676, 681, 2005 WL 3285050, at *5 (U.S.).

In *Chickasaw Nation*, the Supreme Court held that Oklahoma could not impose its motor fuel tax on fuel sold by the Tribe on its reservation because the legal incidence of the tax rested on the tribal retailer. 515 U.S. at 453, 115 S.Ct. at 2217. Conversely, in *Wagnon*, the Supreme Court held that Kansas could impose its motor fuel tax on non-Native American distributors who received the fuel off-reservation even though the distributor subsequently passed on the tax to the Native American retailer when delivering the fuel. 126 S.Ct. 676, 2005 WL 3285050. Like *Wagnon*, the "legal incidence" of the City's transaction privilege tax is fairly interpreted to rest on Leisure Development. Flagstaff City Tax Code § 3-5-427(a) provides that the tax shall be paid by "every person engaging or continuing in the business activity of selling manufactured

buildings within the City." Such language is clearly indicative of who bears the legal incidence of the tax.

Thus, if the transactions occur on-reservation ***and*** the legal incidence of the tax rests on Leisure Development, then the Court must determine whether the tax is valid under the interest-balancing test set forth in *White Mountain Apache Tribe v. Bracker*, 448 U.S. 136, 100 S.Ct. 2578 (1980). The *Bracker* interest-balancing test only applies where a tax is imposed on non-Native Americans engaging in activity on the reservation, it does not apply where a state tax is imposed on non-Native Americans and arises as a result of transactions occurring off the reservation. *Wagnon*, 126 S.Ct. at 680, 2005 WL 3285050, at *3.

In *Bracker*, a non-Native American logging company felled trees on the Fort Apache Reservation and transported them to a tribal sawmill. 448 U.S. at 139, 100 S.Ct. at 2581. The Supreme Court held that federal law preempted Arizona's motor carrier license tax and use fuel tax imposed on the non-Native American company. *Id.* at 138, 100 S.Ct. at 2581. The Court stated that where a state asserts authority over the conduct of non-Native Americans engaging in activity on the reservation, an inquiry must be made "into the nature of the state, federal, and tribal interests at stake, an inquiry designed to determine whether, in the specific context, the exercise of state authority would violate federal law." *Id.* at 145, 100 S.Ct. at 2584. The Court determined that the Federal and tribal interests in regulating tribal timber and tribal roads outweighed the State's generalized interest in raising revenue. *Id.* at 150, 100 S.Ct. at 2587.

Even if the *Bracker* interest-balancing test were to apply to the case at bar, the City's interests clearly outweigh any federal or tribal interests. The City's transaction privilege tax is used to pay for services provided by the City (i.e., roads, utilities, etc.). Leisure Development was undoubtedly benefiting from these services by having its sales lot located in Flagstaff. The Native Americans traveling to Leisure Development's sales lot are also benefiting from these services. Therefore, even if Leisure Development's sales of manufactured homes to Native Americans were considered to have occurred on-reservation, the City's imposition of its transaction privilege tax on the sales would still be constitutional.

B. THE CITY'S USE OF THE SAMPLING METHOD

The Court disagrees with the City's argument that Leisure Development is precluded from challenging the City's use of the sampling method during the City's audit because Leisure Development failed to raise the issue at the Municipal Tax Hearing. After reviewing the Municipal Tax Hearing Transcript, the Court believes Leisure Development adequately raised the sampling issue both at the Municipal Tax Hearing and in its opening brief to the Municipal Tax Hearing Officer.

However, the Court finds that Leisure Development has failed to present any factual evidence to controvert the City's use of sampling to establish unreported income. The only evidence Leisure Development provides to refute the use of sampling is the Affidavit of its

accountant, Ms. DeWilde, in which she summarily opines that a sales tax audit based on sampling is inherently erroneous and is not appropriate in this case. This conclusory statement is insufficient to create a genuine issue of material fact.

Conversely, according to Flagstaff City Tax Code § 3-5-55(d), "[t]he Tax Collector may use any generally accepted auditing procedures, including sampling techniques, to determine the correct tax liability of any taxpayer." In addition, the Tax Auditor Training Manual used by both the Cities of Phoenix and Flagstaff provides that sampling is an appropriate method to use when conducting audits. Although the City may wish to re-examine its use of sampling with low-volume, large-ticket items, Leisure Development has failed to provide any substantial evidence to demonstrate that the use of sampling was erroneous in this instance. Therefore, the Court must conclude that the City's use of sampling was reasonable and should be approved.

The Court finds that there are no genuine issued of material fact and Defendant is entitled to judgment as a matter of law.

IT IS THEREFORE ORDERED granting Defendant's Motion for Summary Judgment.

IT IS FURTHER ORDERED denying Defendant's Motion to Strike.

IT IS FURTHER ORDERED vacating the trial set May 5, 2006.