OVERVIEW OF SETTLEMENT TRUSTS AFTER 2017 TAX ACT

May 2018

Today

- Discussion Provides Information About Settlement Trusts ("STs") and 2017 Tax Act
- Presentation Assumes a General Understanding of STs, so discussion will be somewhat technical
- Feel Free to Ask Questions During Presentation
- Not to be considered as legal or tax advice by OHNC or its consultants

BACKGROUND OF STs

Purpose of STs Per 1988 Legislation

- P. L. 100-241 authorized Alaska Native Corporations to establish STs

- Per ANCSA 39(b)(1), the purpose of an ST is "to promote the health, education, and welfare of its beneficiaries and preserve the heritage and culture of Natives"

Purpose of STs Per 1988 Legislation

- Legislative history of P. L. 100-241 provides that STs are
  - To exist as permanent, Native-oriented institutions to hold and manage Native land assets in perpetuity.
  - To provide for the health, education and economic welfare of the individual Natives who are the Settlement Trust's beneficiaries.

Source: House Explanatory Statement, 133 *Cong. Rec.* H 11933 (December 21, 1987); S. Rept. 100-201 at 34-35 (1987).

ANCSA Section 3(t) Definition of ST

(t) “Settlement Trust” means a trust—

(1) established and registered by a Native Corporation under the laws of the State of Alaska pursuant to a resolution of its shareholders, and

(2) operated for the benefit of shareholders, Natives, and descendants of Natives, in accordance with ANCSA §39 and the laws of the State of Alaska.

ST Benefits

It is not unusual for an ST to provide more than one type of benefit. Most common:

- ***Pro rata Income Distributions***
  - replaces or supplements corporate dividends
- ***Education Grants/Scholarships***
  - Avoids deductibility problems with foundations
  - Structure, Amounts in Trustees' discretion

ST Benefits, Continued

- ***Funeral/Burial/Potlatch Benefits***
  - Structure, Amounts in Trustees' discretion
- ***Elders' Benefits***
  - Original Shareholders
  - Aged 65
  - payments for life vs 1 lump sum

ST Benefits, Continued

- ***Land-based Benefits (ANCSA Land placed in Trust)***
  - Hunting, fishing, other subsistence
  - Hold ANCSA land in perpetuity
  - Other Uses permitted
  - ANCSA Land Cannot Be sold
  - Subdivision Issue

Tax Aspects of STs vs. ANCs

Key Tax Concepts

- ANC may elect a tax deduction for transfers to ST
- ST has income in same amount (ST may defer if contribution not cash)
- ST pays a 10% tax on its ordinary income, 0% on capital gains and dividends received
- Beneficiaries have no tax on ST income that is distributed

Tax Concepts, Continued

- Benefits provided through a settlement trust are provided on a pre-tax basis, so in effect, tax savings help fund benefits

- Use of a settlement trust rather than the Native Corporation is a far superior approach in most cases

This is illustrated by the following two slides

What must be earned by an ANC to provide $1 million of Net Benefits?

	If Paid Directly From ANC	***If Paid Indirectly through ST***
Earned by ANC or ST	$ 1,500,000	$1,111,000
Tax to Entity	(420,000) (@28%)	(111,000) (@10%)
Before Tax Distribution	$ 1,080,000	$ 1,000,000
Tax To Recipients	($80,000) (@7.5%)	($0) (@0%)
Desired Net Distribution	$1,000,000	$1,000,000

What Recipients ACTUALLY Keep From $1 million of corporate earnings distributed by the ANC versus an ST ?

	Directly From ANC	***Indirectly through ST***
Assumed Income	$1,000,000	$1,000,000
Entity Tax (assumes no NOLs or other carryovers)	(280,000) (28%)	(100,000) (10%)
Available for Distribution	$ 720,000	$ 900,000
Tax to Shareholders vs Beneficiaries	(54,000) (7.5%)	(0)
Kept By Shareholders or Beneficiaries	$ 666,000 **(66%)**	$900,000 **(90%)**

ALASKA CORPORATE LAW - PRO RATA RULE vs. ANCSA §7(r)

ALASKA LAW – PRO RATA RULE FOR CORPORATIONS

- A.S. § 10.06.305(b) provides as follows:

  "(b) All shares of a class shall have the same voting, conversion and redemption rights and other rights, preferences, privileges, and restrictions * * *."
- Failure to follow this rule can lead to disastrous consequences (example: Kake Tribal bankruptcy)

ANCSA §7(r) Exception

- (r) **Benefits for shareholders or immediate families**. The authority of a Native Corporation to provide benefits to its shareholders who are Natives or descendants of Natives or to its shareholders' immediate family members who are Natives or descendants of Natives to promote the health, education, or welfare of such shareholders or family members is expressly authorized and confirmed. Eligibility for such benefits need not be based on share ownership in the Native Corporation and such benefits may be provided on a basis other than pro rata based on share ownership.

ALASKA NATIVE PROVISIONS OF 2017 TAX ACT

REASONS FOR 2017 ALASKA NATIVE PROVISIONS

“Reasons for Change

The Committee believes that restrictions on the activities and assets of Settlement Trusts may discourage contributions by Native Corporations. The Committee further believes that Settlement Trusts are effective tools for reducing dependence on state and federal welfare programs in Alaska Native communities. More generally, the Committee believes that it is desirable to promote the funding of Settlement Trusts as a means to improve the health, education, and welfare of the Settlement Trusts' beneficiaries.”

Source: Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71,* S. Prt. 115-20, (December 2017), p.308, as reprinted on the website of the Senate Budget Committee, available at www.budget.senate.gov/*taxreform*.

Assignments of ANCSA mandated payments: §139G

Assignments of ANCSA mandated payments-- §139G

- Permits Native Corporations to exclude advance assignments of certain payments required by ANCSA (including those under ANCSA §7(j)) to an ST
- ST (and not the assigning ANC) is the proper taxpayer to report assigned income

Assignments of ANCSA mandated payments-- §139G

- Not limited to 7(j) payments – includes payments otherwise made “made, or treated as being made, to such Native Corporation pursuant to, or as required by, any provision of” ANCSA
- Documentation: Written Advance Assignment (Best if Notarized Agreement)
- Effective date: Years beginning after 12/31/2016

Deductible Contributions: §247

Elective Deduction for Contributions to an ST - §247

- Annual Revocable Election That applies to all contributions during that taxable year of the ANC
- Deduction Amount: Lesser of (i) FMV or (ii) Adjusted Basis
- Deduction limited to taxable income
- Unused Contributions carried over (not back) for 15 years

Elective Deduction for Contributions to an ST - §247

- Subject to §247(g), ST has income equal to amount ANC could deduct
  - this raises ST income for all purposes
  - this includes determination of tax free distributions to beneficiaries
- ST's basis is lesser of ANC's basis or FMV
- ST's holding period includes ANC period
- No deduction for contribution of prohibited assets

ST Elective Deferral of Income from Contributions - §247(g)

- Applies to contributions of non cash assets
- Allows Income deferral until asset sold
- Does not defer deduction by ANC
- ST must hold for complete taxable year after contribution received
- Recapture and penalty if ST disposes
- ST can revoke election

Effective Date for §247

- Applies to any year as to which the statute of limitations for a refund is open
- Generally three years
- If Statute of limitations for a year is open on 12/22/2017, election can be made retroactively
- Could produce a refund if ANC initially made a non deductible contribution within refund period and then amends (1120X)

Information Reporting: §6039(H)(e)

§6039H(e) Reporting for Deductible Contributions

- ANC obligating to provide information to ST concerning deductible contributions
- Deadline: 1/31 after §247 any year in which deductible contribution is made
- Applies to 2017 contributions
- Deadline for reporting has already past

IRS Materials on 2017 Tax Act

IRS Follow Up on 2017 Tax Act

- Only IRS Pronouncement so far is IRS Newswire IR-2018-6 (January 30, 2018) (electronic)
- IR-2018-6 reminds ANCs of obligation to provide information reporting to STs by the next day, 1/31/2018
- IR-2018-6 incorrectly references a part of the legislation that was deleted during Senate deliberations in early December

IRS Follow Up on 2017 Tax Act

- IR-2018-6 has no substantive discussion of Alaska Native provisions of 2017 Tax Act
- Unknown whether IRS will issue regulations concerning ANCSA provisions of 2017 Tax Act
- ANCs could seek to influence Treasury/IRS concerning 2017 Tax Act, but this should be coordinated and not haphazard
- Open to question whether further IRS guidance will be helpful

Selected Issues Concerning 2017 Tax Act

Priority of §247 vs. §170 Charitable Deduction

- §170 allows deduction of 10% of taxable income
- §170 excludes "Part VIII" deductions and NOL deduction in computing taxable income for §170 purposes
- Conclusion: the §170 charitable contribution comes first

Priority of §247 vs. §172 Net Operating Loss Deduction

- §172 allows NOL deduction = to 80% of taxable income (post 2017)
  - ignores only NOL deduction
  - Unused NOLs: unlimited carryover
- §247 allows ST deduction = to 100% of taxable income
  - ignores only ST deduction
  - Unused Deductions : 15 year carryover
- Arguably, Indian nature of §247 controls

Accumulated Earnings Tax and §247

- §531 imposes a 20% tax on "accumulated earnings" of §532 corporations
- §532 corporations are those "formed or availed of" to avoid tax by accumulating E&P
- Not the case with ANCs claiming §247 deduction, since E&P is reduced
- In any event, Indian nature of §247 controls

Did The 2017 Tax Act Change ST Tax Rates?

- Early in the legislative process, the House proposed increasing the tax rates on STs to a flat 12% on all ST income
- Due to timely intervention by Alaska Delegation, no change was made
- Thus, after the 2017 Tax Act, STs remain taxed at 10% on ordinary income and 0% on long term capital gains and qualifying dividends

CONCLUSION

Remarkable Achievements

- By any measure, §247 and §139G are remarkable achievements
- Provide powerful incentive for ANCs to begin or increase contributions to STs
- Other important Indian provisions (IETC, Indian Coal Credit, accelerated depreciation) not included in 2017 Tax Act

Remarkable Achievement

- Although in appropriate circumstances, dividends can be made through STs on a deductible basis, ANCs should use STs for broader social purposes as well
- Risk is that if this is not done, support and protection of Alaska Delegation could be lost
- Congress may reduce or eliminate benefits if ANCs perceived to be abusive
- Example loss of ability to sell ANC NOLs

QUESTIONS?