OVERVIEW OF ALASKA NATIVE CORPORATION SETTLEMENT TRUSTS AFTER 2017 TAX ACT

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Holland & Knight

Introduction

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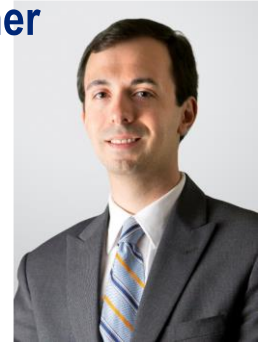

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Why Create And Use A Settlement Trust?

- With the 2017 Tax Cuts and Jobs Act, Alaska Native Corporations now have an extraordinary opportunity to leverage Settlement Trusts for the benefit of the Native Corporation and its Shareholders
- Settlement Trusts pay 10% income tax and 0% net capital gains tax
- Native Corporations can deduct contributions to Settlement Trusts
- Distributions by Settlement Trusts to their beneficiaries (i.e., the shareholders) should be tax-free to the beneficiaries
- Now is the time to consider creating a Settlement Trust and leveraging its unique characteristics to reduce or eliminate federal tax liability and increase the amount of distributions received and kept by shareholder beneficiaries
- If you have created a Settlement Trust, there are unique opportunities to further leverage Settlement Trusts beyond distributions to shareholders

Topics to be Addressed

- What is a Settlement Trust?
- What are the benefits of a Settlement Trust?
- What are the limitations of a Settlement Trust?
- How can a Settlement Trust be leveraged to the benefit of the Native Corporation and its shareholders?

Definition and Purpose of Settlement Trust

- **Definition: A Settlement Trust is a trust**
  - established and registered by an Alaska Native Corporation under the laws of the State of Alaska pursuant to a resolution of its shareholders, and
  - operated for the benefit of shareholders, Natives, and descendants of Natives, in accordance with ANCSA §39 and the laws of the State of Alaska.

- **Purpose: The purpose of a Settlement Trust is to**
  - promote the health, education, and welfare of its beneficiaries and preserve the heritage and culture of Natives,
  - exist as permanent, Native-oriented institutions to hold and manage Native land assets in perpetuity, and
  - provide for the health, education and economic welfare of the individual Natives who are the Settlement Trust's beneficiaries.

Formation of Settlement Trusts

- » Requires a vote of the Shareholders of the sponsoring Native Corporation to create
- » The Board of Directors of the sponsoring Native Corporation then decides what is contributed
  - – Shareholder vote required to contribute all, or substantially all, of the sponsoring Native Corporation's assets
- » More than one Settlement Trust can be created by a Native Corporation
  - – Elders Trust
  - – Education Trust

Management of Settlement Trusts

» Governed by a Trust Document
  - Similar to Native Corporations' Articles of Incorporation/Bylaws

» Board of Directors of sponsoring Native Corporation has the power to appoint Trustees
  - Trustees must be natural persons

» Broad Flexibility
  - Dedicated funds
  - Trustee Structure
    - Native Corp Employees or ANC Board of Directors?

Management of Settlement Trusts

- Typically managed on a day-to-day basis by Native Corporation
  - Written Management Agreement
- Investment Policy adopted and monitored by Trustees
- Conduct own audit and maintain separate books and Tax ID number

Settlement Trusts Characteristics

- Settlement Trust pays a 10% tax on its ordinary income, 0% on net capital gains and 0% on qualified dividend
- Spendthrift Trust
- Same protections regarding land as Alaska Native Corporations, including exempting of non-developed land from real property taxes

Settlement Trust Limitations

- Cannot Operate A Business
  - Can own securities, including LLC membership interests
  - Passive investments
    - Leasing
    - Private placements
    - Transactions with sponsoring Native Corporation
- Cannot alienate interest in land received from sponsoring Native Corporation
  - Exception for conveying back to sponsoring Native Corporation or to shareholders of sponsoring Native Corporation for homestead lots
- Cannot receive subsurface estate from sponsoring Native Corporation or sell timber

Settlement Trusts Benefits – Land Transfers

- Can place land, including ANCSA land, into the Settlement Trust
  - The Settlement Trust will hold the land in perpetuity
  - Land cannot be sold by the Settlement Trust except back to the Native Corporation
  - Cannot directly contribute subsurface estate to Settlement Trusts
  - Contribution may expose land to property taxes if land is subdivided prior to transfer to Settlement Trust

Settlement Trusts Benefits

- Defined by the Trust Document, and can include:
  - Pro Rata Distributions
  - Per Capita Distributions
  - Education Grants/Scholarships
  - Death Benefits
  - Elder Benefits
  - After-Borns/Alaska Native shareholders

Settlement Trusts Benefits – Tax-Free Distributions

» Distributions by Settlement Trust can be non-taxable to its beneficiaries

Tier 1 – Tax-Free:	Distributions up to Settlement Trust's taxable income
Tier 2 – Tax-Free:	Distributions up to Settlement Trust's accumulated non-distributed taxable income
Tier 3 – Taxable:	**Distributions in excess of Settlement Trust's accumulated taxable income, up to sponsoring Native Corporation's retained earnings/net profit**
Tier 4 – Tax-Free:	Distributions in excess of Settlement Trust's accumulated taxable income and sponsoring Native Corporation's retained earnings/net profit

Settlement Trusts Benefits – Tax-Free Distributions

Tier 1 Example:

$1,000,000 in Settlement Trust taxable income in 2019
$100,000 in taxes paid in 2019

$1,000,000 - $100,000 = $900,000

First $900,000 distributed by Settlement Trust in 2019 is Tax-Free

Tier 2 Example:

Same as above, but Settlement Trust had $1,000,000 in taxable income in 2018 that was not distributed

$1,000,000 - $100,000 + $1,000,000 - $100,000 = $1,800,000

$1,800,000 can be distributed by the Trust in 2019 Tax-Free

Settlement Trusts Benefits –Tax-Free Distributions

Tier 3 Example:

$500,000 in Settlement Trust taxable income in 2019
$50,000 in taxes paid
$0 in retained earnings in Settlement Trust
Settlement Trust Distributes $1,000,000
Native Corporation has net profit of $2,000,000

Tier 1: $450,000 Tax-Free
Tier 2: $0 Tax-Free
Tier 3: $550,000 Taxable
Tier 4: $0 Tax-Free

Settlement Trusts Benefits – Tax-Free Distributions

Tier 4 Example:

$500,000 in Settlement Trust taxable income in 2019

$50,000 in taxes paid

$0 retained earnings in Settlement Trust

Settlement Trust Distributes $1,000,000

Native Corporation has net profit of $0 and retained earnings of $100,000

Tier 1: $450,000 Tax-Free

Tier 2: $0 Tax-Free

Tier 3: $100,000 Taxable

Tier 4: $450,000 Tax-Free

Alaska Native Provisions of 2017 Tax Act

Deduction for Contributions to a Settlement Trust

- Each year, the sponsoring Native Corporation can elect to deduct its contributions to its Settlement Trust

- The deduction amount is the lesser of:
  - **Fair Market Value** of contribution, or
  - Native Corporation's **adjusted tax basis** in the asset contributed

- Deduction limited to the sponsoring Native Corporation's taxable income

- Unused contributions carried over (not back) for 15 years

Deduction for Contributions to a Settlement Trust

- Settlement Trust will have income in the amount of the contribution

- Settlement Trust pays
  - **10% tax on its ordinary income**
  - **0% on capital gains and dividends received**

- By January 31st, the sponsoring Native Corporation must report to the Settlement Trust the amount and nature of any contribution by the sponsoring Native Corporation in the prior year - §6039(H)(e)

Non-Cash Contributions to a Settlement Trust

- If the sponsoring Native Corporation contributes a **non-cash asset**, the Settlement Trust can defer recognition of income until the sale of that non-cash asset
  - Land
  - Art
  - Buildings
  - Marketable securities
- The Settlement Trust's basis in the non-cash asset is the **lesser of** the Native Corporation's
  - adjusted tax basis, or
  - the fair market value of the non-cash asset

NO DEFERRAL OF CASH CONTRIBUTIONS

Non-Cash Contributions to a Settlement Trust

» The Settlement Trust's holding period includes the contributing Native Corporation's period

» No deduction for contribution of prohibited assets (i.e., subsurface estates)

Any election by the Settlement Trust to defer recognition of income does not prevent the contributing Native Corporation from taking an immediate deduction

Non-Cash Contributions to a Settlement Trust

- For non-cash assets that the Settlement Trust elected to defer recognition of income, the Settlement Trust must hold the asset for a complete taxable year after year in which the contribution is made

- If the Settlement Trust sells within that holding period then:
  - The Settlement Trust is deemed to have income in the year of the contribution
  - The Settlement Trust will have to pay interest on the taxes that were owed on that contribution
  - The Settlement Trust will be subject to an additional 10% tax penalty

Non-Cash Contributions to a Settlement Trust

EXAMPLE: INCOMPLETE DEFERRAL PENALTY

» In 2018, Native Corporation contributes stock having an adjusted basis of $100,000 to Settlement Trust and long-term unrealized capital gains of $50,000

» Settlement Trust makes election on 2018 tax return to defer recognition of income related to that contribution

» Settlement Trust sells stock in 2019

» Settlement Trust's 2018 tax return must be amended to include $100,000 of taxable income, with the Settlement Trust owing $10,000 of taxes, plus interest accruing from 2018, plus an additional $1,000 tax penalty

Non-Cash Contributions to a Settlement Trust

- Settlement Trust can revoke election to defer recognition of income
- Tax penalty only applies to non-cash assets for which an election to defer recognition of income is made
- If Settlement Trust does not make an election, it can immediately sell the non-cash asset contributed by the Native Corporation

Non-Cash Contributions to a Settlement Trust

EXAMPLE: NO DEFERRAL ELECTION

» In 2018, Native Corporation contributes stock having an adjusted basis of $100,000 to Settlement Trust and long-term capital gains of $50,000

» Settlement Trust does not make election on 2018 tax return to defer recognition of income related to that contribution

» Settlement Trust sells stock in 2019

» Settlement Trust's 2018 tax return will include $100,000 of taxable income, with the Settlement Trust owing $10,000 of taxes – 10% on the $100,000 adjusted tax basis. When the Settlement Trust sells the stock in 2019, it realizes $50,000 taxable income on which it pays 0% tax because it is long-term capital gain

Leveraging Settlement Trusts

Leveraging Settlement Trusts

» **Restrictions**
  - Cannot operate a business
  - Cannot contribute subsurface estate

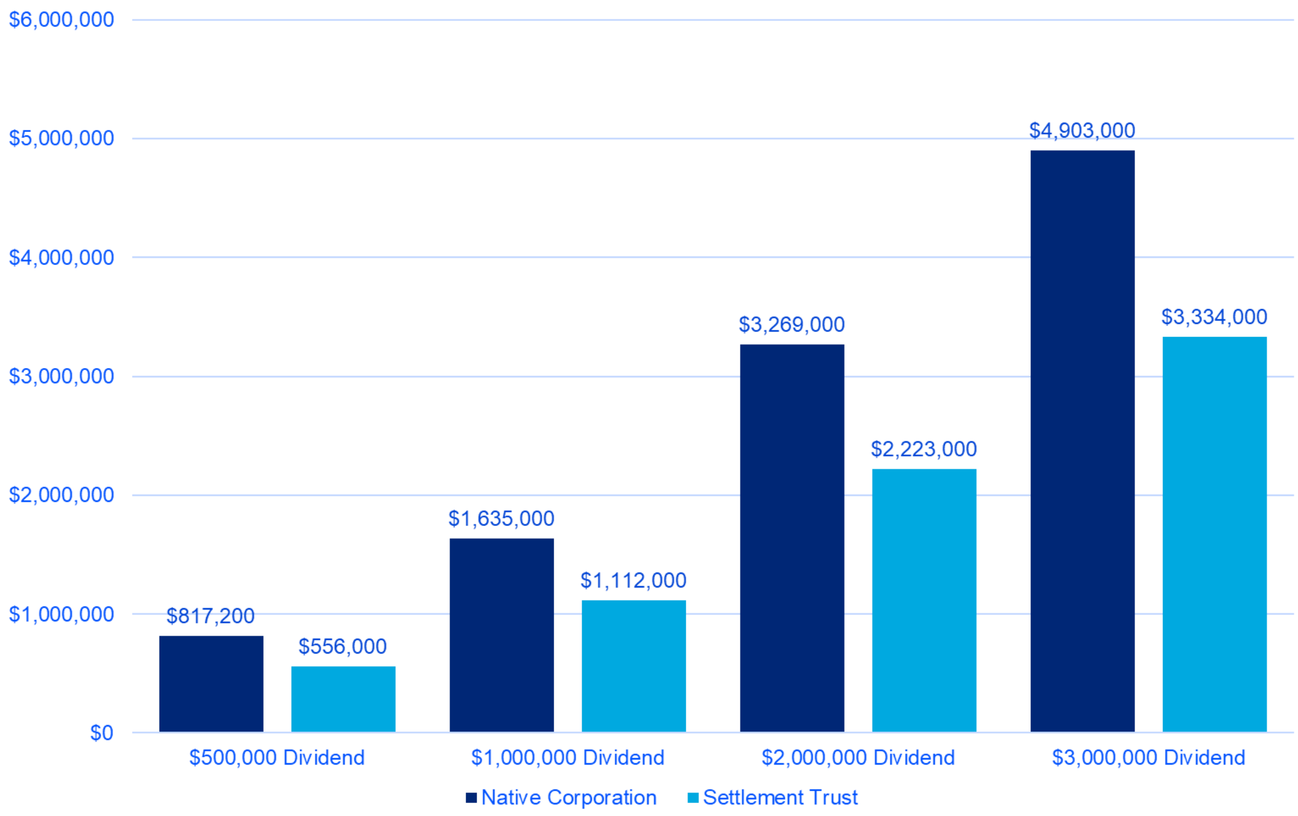
» **Consequences**
  - **Contribution of subsurface estate**
    - Transfer is void ab initio
    - Disallowance of tax deduction, plus interest and penalties
    - Dissenting shareholder suit against Board of Directors
    - Section 7(i) sharing risks
  - **Operating a Business**
    - Determined to no longer be a Settlement Trust
    - Loss of tax benefits
    - Deemed Grantor Trust of ANC

» **Risk/Reward Analysis**
  - Many undecided areas of law
  - Likelihood of enforcement action
  - Time sensitive issue?

Earnings Necessary to Provide $2,000,000 in Actual Benefit to Shareholders

- Assumptions:
  - 28% tax rate for Native Corporation
  - 10% tax rate for Settlement Trust
  - 15% tax rate paid by shareholders on Native Corporation dividends
  - 0% tax rate paid by shareholders on distributions by Settlement Trust

Pre-Tax Earnings Necessary to Fund Dividends and Distributions



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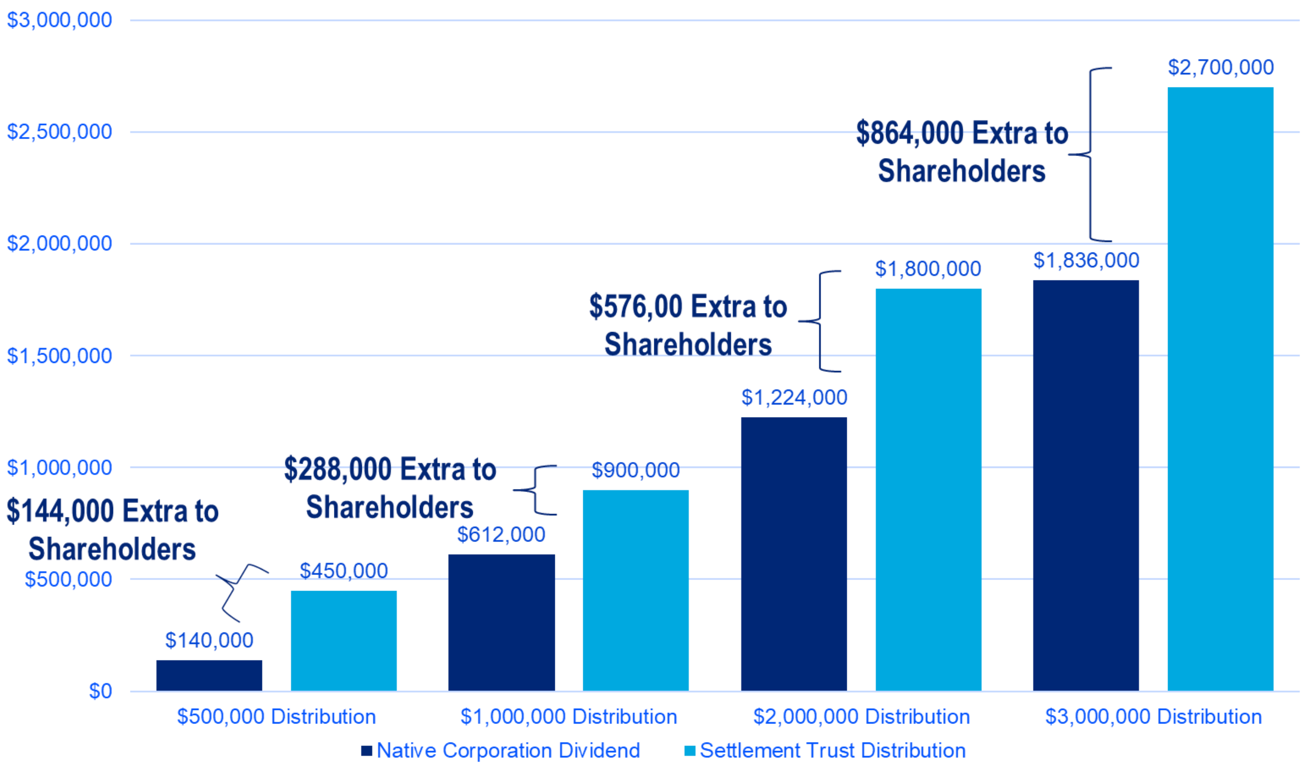
Comparing Amount Received by Shareholders from Dividends by Native Corporation vs. Distributions by Settlement Trust



Types of Contributions to Settlement Trusts

- Only restriction is cannot contribute subsurface estate directly to Settlement Trusts

- Permissible Contributions:
  - Cash
  - Marketable Securities
  - Surface Estate
  - Art
  - Buildings
  - Promissory Notes
  - 7(j) Payments

Marketable Securities

Settlement Trust = Tax Deduction

Tax Free Capital Gains

- Contribute marketable securities with the following attributes:
  - Adjusted tax basis of $500,000
  - Current fair market value of $1,000,000
  - Any realized gain will be characterized as long-term capital gains
- $500,000 tax deduction for ANC
- Trust pays $50,000 in income tax ($500,000 x 10%)
- Trust sells securities for $1,000,000
- Trust pays $0 in income tax on gain realized from sale ($500,000 long-term gain x 0%)
- $500,000 in non-taxed gain to Trust
- Trust can also elect to defer recognition of income until it sells securities
  - Built-in mechanism for generating taxable income for Trust to insure distributions are tax-free
  - Can time sale of marketable securities based on market and cash needs for distributions or other investments
  - Qualifying dividends from securities are taxed at 0% to the Settlement Trust

Surface Estate Transfers

Settlement Trust

Tax Deduction

No Taxable Income to Trust

- Contribute ANCSA surface estate with the following attributes:
  - Adjusted tax basis of $20,000,000
  - Value of land upon conveyance to ANC in 1979
  - Current fair market value of $40,000,000
  - Traditional land for which there is no intent to sell or develop
- $20,000,000 tax deduction for ANC
  - Lesser of adjusted tax basis or current fair market value
- Trust elects to defer recognition of income until it sells the land
  - No intention to ever sell the land
- Trust pays $0 in income tax based on contribution
- $20,000,000 tax deduction to ANC for preserving land in perpetuity

Art Transfers

Settlemen
t Trust

Tax
Deduction

No Taxable
Income to
Trust

- Contribute Native Art with the following attributes:
  - Adjusted tax basis of $1,000,000
  - Current fair market value of $1,500,000
  - Native Art for which there is no intent to sell
- $1,000,000 tax deduction for ANC
  - Lesser of adjusted tax basis or current fair market value
- Trust elects to defer recognition of income until it sells the Native Art
  - No intention to ever sell the Native Art
  - Licenses Native Art back to Native Corporation
- Trust pays $0 in income tax based on contribution
- $1,000,000 tax deduction to ANC for contributing Native Art

Other Options

- Intellectual property rights
  - Grant license back to Native Corporation to use/license to third parties
  - Generates tax deduction

- Uncollected judgments
  - Potential income/revenue to the Settlement Trust when collect on judgment
  - Generates tax deduction

- Promissory Notes from third parties or subsidiaries
  - Interest and/or principal component
  - Generate revenue for Settlement Trust
  - Potential tax deduction

Assignments of ANCSA Mandated Payments - §139g

» Prior tax regime required Native Corporations to pay tax on value of income streams assigned to Settlement Trusts

» Native Corporations may now exclude from their income advance assignments of payments required by ANCSA (including those under ANCSA §7(j)) to a Settlement Trust

» The Settlement Trust (and not the assigning Native Corporation) pays taxes on the assigned income

Assignments of ANCSA Mandated Payments - §139g

- Includes all payments otherwise "made, or treated as being made, to such Native Corporation pursuant to, or as required by, any provision of" ANCSA

- Documentation: Written Advance Assignment

- Assignment can be of all or a percentage and be either irrevocable, revocable, or for a period of time

Non-Cash Benefits to Trust Beneficiaries

- Settlement Trusts can, and should, be used to provide social, cultural, and other benefits, beyond cash distributions

- Congressional concern is that Settlement Trusts will become permanent funds with no role other than replacing dividends

- Desire is for Settlement Trusts to provide a full range of benefits, including cultural, educational, heritage, preservation, elder-care, and community enhancement

Non-Cash Benefits to Trust Beneficiaries

» Greater emphasis on benefits of share ownership other than dividends

» Eligibility for:
  - Scholarships and Vocational Assistance
  - Hiring Preference
  - Housing Assistance
  - Medical Benefits
  - Death Benefits
  - Elders Benefits
  - Social Welfare Programs

Non-Cash Benefits to Trust Beneficiaries

» Death Benefits

- » One amount for Shareholders
- » Separate amount for Descendants

» Housing and Medical Assistance

- » Cannot provide housing/medical assistance directly (i.e. cannot run an apartment complex or medical clinic)
- » Can fund other entities that do provide those services
- » Partner with non-profit to fund services provided by non-profit to beneficiaries

» Vocational Opportunities

- » Partner with non-profits or other entities to fund internships for shareholders and descendants

Non-Cash Benefits to Trust Beneficiaries

- Elders Benefits
  - One time cash payments upon reaching 65
  - Monthly/quarterly payments
- Educational Programs
  - Fund educational opportunities in the villages
  - “Night at the Museum” – fund trip by Alaska Native historians to come to villages to talk with children in the communities
- Charitable Giving
  - Funnel charitable giving through the Settlement Trust
  - Native Corporation contributes what it would have contributed to charities to Settlement Trust and the Settlement Trust then makes contributions to the charities

Legislative Issue

- ANCSA excludes the first $2,000 of payments from an Alaska Native Corporation to a shareholder when determining eligibility for certain benefits
- Does not explicitly include Settlement Trusts in the exemption
- Current practice is to treat payments from Native Corporation and Settlement Trust as the same, but that could change
- Given State budget issues, State may be looking at ways to reduce number of Alaska Natives eligible for benefits by including Settlement Trust income when determining their eligibility
- Legislation to increase exemption amount to $5000 and to include Settlement Trusts has been proposed

Trust Document Considerations

- Register Settlement Trust prior to contributions

- Include explicit authority for Trustees to approve transactions with Native Corporation

- Permit amendments to the Trust Document

- Composition of Trustees/Term limits for Trustees

Summary

- Settlement Trusts can provide a massive benefit to Native Corporations and their Shareholders
- Can be used to increase distributions to Shareholders, lower Native Corporation’s taxes, and provide more benefits to Alaska Natives
- Seizing opportunities provided by Settlement Trusts requires strategic planning and risk assessment in a legal environment where there is not much law or clarity

Questions?

Thank You!

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Walter T. Featherly focuses his practice on Alaska Native- and Native American-owned businesses. He regularly counsels boards of directors and executives on matters including corporate law and governance, the Alaska Native Claims Settlement Act, the Alaska National Interest Lands Conservation Act, business transactions, mergers and acquisitions, government contracting, labor and employment, finance and real estate.

»Mr. Featherly also assists Alaska Native Corporation and tribal-owned businesses to navigate the laws and regulations of the Small Business Administration's (SBA) 8(a) Business Development and the Historically Underutilized Business Zones (HUBZone), particularly those related to subcontracting and teaming opportunities.

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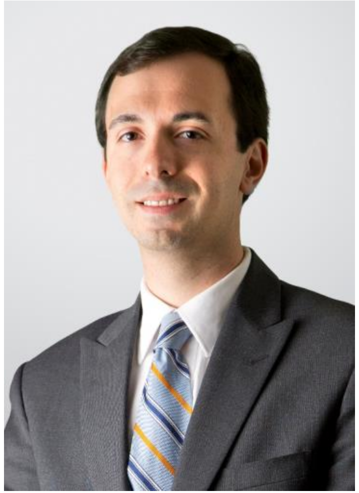
Christopher Slottee is highly experienced in matters related to Alaska Native Corporations (ANCs), Alaska Native Corporation settlement trusts, tribal governments and Indian Country, having served as vice president and general counsel for an ANC.

»As part of his practice, Mr. Slottee handles complex litigation on behalf of both plaintiffs and defendants in areas involving commercial transactions, healthcare, construction disputes, employment law, medical and legal malpractice, personal injury, municipal government, insurance bad faith, and ANC and tribal matters. He is well-versed in advising ANCs and their subsidiaries on corporate governance, legal and risk management issues, business transactions, mergers and acquisitions, and real estate matters.

»Mr. Slottee also has a significant background in providing legal and strategic advice, specifically in government contracting, tourism, oil field services, telecommunications, investments, risk management, and acquisitions and divestitures. He also provides guidance on the Small Business Administration's (SBA) Section 8(a) Business Development Program and on the establishment and management of Alaska Native Corporation settlement trusts.



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Robert J. Misulich regularly represents Alaska Native Corporations (ANCs) as outside corporate counsel in a broad range of matters, including corporate governance, shareholder meetings, proxy solicitations, business transactions and compliance.

»In addition to his transactional practice, Mr. Misulich has represented Alaska companies and public entities in a broad range of litigation matters, from labor and employment to personal injury, property damage and inverse condemnation cases. Some of his recent accomplishments include successfully obtaining a temporary restraining order and preliminary injunction in a trade secrets lawsuit, complete dismissal of a significant permanent injury/disability case, reversal of an erroneous fee award against public interest litigants, and the successful representation of an Alaska tribe in an Indian Child Welfare Act (ICWA) case.

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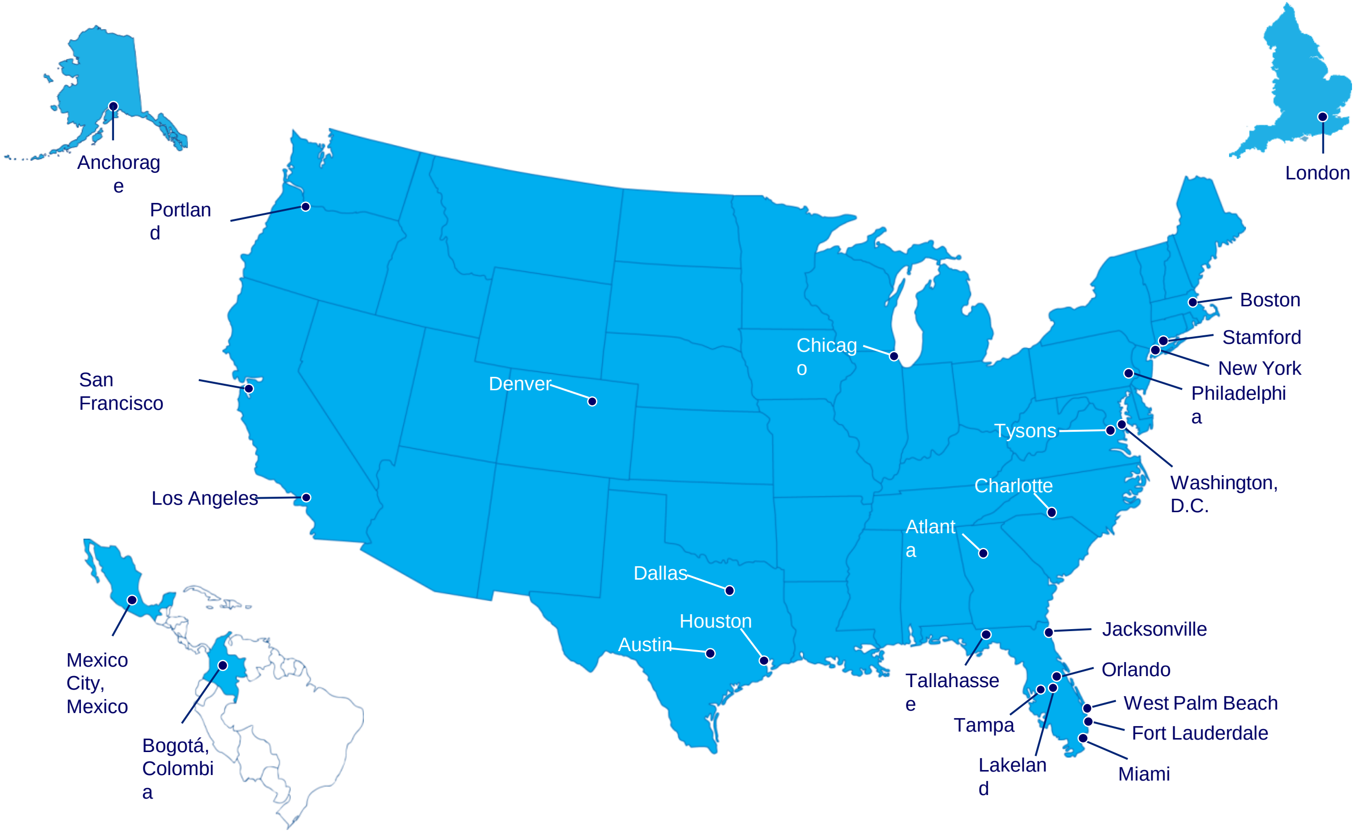

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