BDO KNOWS: TAX REFORM

Alaska Native Settlement Trusts

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With you today

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Agenda

- Overview of Alaska Native Settlement Trusts (ANST)
- Original Tax Rules for ANST’s
- New Tax Rules for ANST’s under the TCAJA
- Corporate Update
- Pass-Through Entities Update

Disclaimer: Today’s presentation is intended to provide a high level overview of certain provisions contained in the new tax law and is not intended to be a comprehensive discussion. For application of the new law to specific cases, a tax advisor should be consulted.
Overview of Alaska Native Settlement Trusts
Alaska Native Settlement Trusts

- Section 1629e of the Alaska Native Claims Settlement Act allows an Alaska Native Corporation to establish a Settlement Trust under Alaska state law.
- Each shareholder of the sponsoring Alaska Native Corporation will become a beneficiary of the Settlement Trust equal to their stock holdings in the corporation.
- The purpose of a Settlement Trust as defined in ANCSA is to “promote the health, education, and welfare of its beneficiaries and preserve the heritage and culture of Natives.”
- Shareholders of the sponsoring ANC must approve through corporate resolution to establish a Settlement Trust and to convey corporate assets.
- It is important to consult an ANCSA attorney to assist in establishing a Settlement Trust pursuant to Alaska state law.
- The sponsoring Native Corporation has the authority to appoint or remove trustees of the Settlement Trust:
  - Only a natural person may be appointed as a trustee.
Limitations on a Settlement Trust

A Settlement Trust may not:

- Operate a trade or business
  - Assets held by a Settlement Trust may only be used in an investment capacity
- Alienate land or an interest in land from the settlor corporation
  - There are few exceptions including land conveyed for homestead by the Trust to a beneficiary
- Discriminate in favor of high ranking employees, officers, or directors of the sponsoring Native Corporation

- No subsurface estate may be conveyed to a Settlement Trust

- No timber resources subject to the provisions of Sec. 1606(i) of ANCSA conveyed to a Settlement Trust may be sold or exchanged
  - Applies to a Regional Corporation under ANCSA
  - Some exceptions apply
Original Tax Rules For An Alaska Native Settlement Trust
Original Tax Treatment of an Electing Alaska Native Settlement Trust

- Prior to the enactment of the Tax Cuts and Jobs Act, IRS §646 provided guidance for the taxation of an electing Alaska Native Settlement Trust.
- A Settlement Trust must make an election on its first return to have the favorable tax treatment of a Settlement Trust.
- Net taxable income was taxed at the lowest individual income tax rate of 10%.
  - Qualified dividends and long-term capital gains taxed at the lowest individual tax rate of 0%.
- A Settlement Trust was not taxed on contributions that it received from the sponsoring Native Corporation, and the sponsoring Native Corporation could not deduct such contributions on their tax returns.
- The sponsoring Native Corporation would incur corporate level gain if appreciated assets were contributed to the Settlement Trust.
Original Tax Treatment of an Electing Alaska Native Settlement Trust (cont.)

▶ Distributions from a Settlement Trust to its beneficiaries fall into four tiers:
  
  - **Tier I** - distributions paid out up to the amount of current year trust net income are non-taxable to the beneficiaries
  
  - **Tier II** - distributions up to cumulative prior years undistributed trust income are non-taxable to the beneficiaries
  
  - **Tier III** - distributions in excess of the previous two tiers are deemed to be made by the sponsoring Native Corporation to the extent of corporate current and/or accumulated earnings and profits; treated as taxable qualified dividends to the beneficiaries
  
  - **Tier IV** - distributions in excess of the first three Tiers are non-taxable distributions to the beneficiaries

▶ Trust taxable income for purposes of distributions is taxable income less income taxes
New Rules Under the Tax Cuts and Jobs Act
Alaska Native Corporation Contribution to Settlement Trust

- Alaska Native Corporation (ANC) may receive a corporate deduction for cash or non-cash property contributed to an Alaska Native Settlement Trust (ANST)

- Contributions of cash provides a deduction equal to cash contributed

- Contributions of non-cash property provides a deduction equal to the lesser of:
  - Adjusted basis of contributed property as held by the corporation immediately prior to the contribution, or
  - Fair market value of contributed property as held by the corporation immediately prior to the contribution

- Deduction claimed by ANC is limited to taxable income
  - Any unused deduction will carryforward for 15 years
Example 1 - Deduction for Contributions of Cash by an Electing ANC to a Settlement Trust

In Year 1, ANC Corp A contributes $100,000 in cash to the related ANST. Without considering a deduction for the contribution, ANC Corp A’s taxable income for Year 1 is $75,000.

What is the deduction allowed in Year 1 for ANC Corp A?

$75,000

What is the amount of unused deduction ANC Corp A may carryforward to future taxable years?

$25,000
Example 2 - Deduction for Contributions of Non-Cash Property by an Electing ANC to a Settlement Trust

In Year 1, ANC Corp A contributes land it purchased in Year 1 into the related ANST. ANC Corp A’s tax basis in the land before the contribution is $50,000, and the fair market value is $100,000. Without considering a deduction for the contribution, ANC Corp A’s taxable income for Year 1 is $75,000.

What is the deduction allowed in Year 1 for ANC Corp A?

$50,000

What is the amount of unused deduction ANC Corp A may carryforward to future taxable years?

$0
ANC Contributions to ANST - Making Election to Claim Deduction

- ANC Contributions to ANST - Making Election to Claim Deduction

ANCs must make an election in order to claim a deduction for contributions to an ANST
  - The election must be made in each year a deduction is carried forward and utilized
  - Election can be made on an amended return, and the election may be revoked on an amended return

ANCs electing to deduct contributions to an ANST must provide a statement to the ANST by January 31st of the calendar year following the year of the contribution. The statement must provide the:
  - Amount of the contribution for which a deduction will be taken,
  - Type of property contributed; for non-cash property include the original acquisition date by the ANC, and the adjusted basis and FMV immediately before the contribution, and
  - Date contribution was made by the ANC to the ANST
ANC Contributions to ANST - Other Important Provisions

- Earnings and profits of the ANC will be reduced by the deduction taken in a given tax year.

- An ANC may amend a previous tax year to claim a deduction for contributions made to an ANST for tax years open under statute.
  - Requirement to provide statement to ANST do not apply to contributions made before January 1, 2017.

- ANC's will not receive a deduction for property contributed to an ANST which are in violation of ANCSA.
  - Subsurface estate in land
  - Timber resources subject to the natural resource revenue distribution rules.
Tax Implications for ANST

- The ANST is required to recognize gain for contributions from an ANC in the year the contribution is made
  - The amount of income recognized equals the total amount of the contribution
    - Note: This amount may differ from the amount of deduction taken by the ANC in the year of the contribution if the ANC deduction is limited by income
- The ANST will take basis in non-cash property equal to the adjusted basis in the ANC immediately prior to the contribution
  - The ANST will assume the same holding period for non-cash property
- If the ANST receives non-cash property then an election can be made to defer gain on the contribution until the contributed property is sold
  - This election will be invalid if the property is sold during the first taxable year following the tax year of contribution
  - The election is made on a timely filed return and is revocable
  - 10% penalty will be assessed for dispositions with an invalid deferral election
- Ordinary income of an ANST is still taxed at the 10% tax rate
Example 3 - Treatment by ANST of Cash Contributions from ANC

In Year 1, ANC Corp A with $75,000 of net taxable income before the contribution, contributes $100,000 in cash to the related ANST.

What amount would Settlement Trust ANST recognize in Year 1?

$100,000

Even though ANC Corp A receives a $75,000 deduction due to the taxable income limitation, the ANST is still required to recognize the full amount in income as it is received in Year 1.
Example 4 - Treatment by ANST of Non-Cash Contributions from ANC

In Year 3 ANC Corp A contributes land it purchased in Year 1 into the related ANST. ANC Corp A’s tax basis in the land before the contribution is $50,000, and the fair market value is $100,000.

What amount would ANST recognize in Year 3 assuming no election to defer income is made?

$50,000

What is the holding period of the contributed land held by ANST?
Date acquired by the ANC in Year 1
Example 5 - Deferral of Gain by ANST of Non-Cash Contributions from ANC

In Year 1, ANC Corp A contributes land it purchased or received in Year 1 into the related ANST. ANC Corp A’s tax basis in the land before the contribution is $50,000, and the fair market value is $100,000. The ANST has made an election to defer gain on the contribution of non-cash property it received in Year 1. The ANST then sold the land in Year 3 for $100,000.

What is the ANST’s realized gain in Year 1?
$50,000

What is the ANST’s recognized gain in Year 1?
$0

What is the ANST’s recognized gain in Year 3 when the land is sold?
$100,000 - $50,000 ordinary income, and $50,000 income having the same character of income had the election to defer the gain not applied
Other Key Provisions for ANC-owned Corporates and ANSTs

- A village corporate may assign its future 7(j) payments to the ANST
  - The assignment may be for all or for a portion of the 7(j) payments
  - Assignment is done by notifying the ANST in writing
  - Assignment may be for a fixed period of time
  - The ANC will not receive a deduction for assigning 7(j) payments
  - The ANC will be taxed for any payments received directly prior to assigning them to the ANST

- The ANST must include in income the 7(j) payments in the year of receipt
What Hasn’t Changed Under the Tax Cuts and Jobs Act for ANSTs

- Income of an ANST is still taxed at the same rates
  - Ordinary income taxed at 10%
  - Qualified dividends and long-term capital gains taxed at 0%
- Distributions to trust beneficiaries still fall into the 4 Tiers
Alaska Native Settlement Trust Takeaways

- Consult an ANCSA attorney to assist in establishing a Settlement Trust pursuant to the Alaska state law and ANCSA
- It is important to properly plan how the sponsoring Native Corporation will fund a Settlement Trust
  - The conveyance of corporate assets should not hinder the sponsoring Native Corporation from running its operations
  - Planning can be done to maximize the full benefits of the new legislation
  - Consult your tax and financial advisor
Corporate Update
Corporate Tax Rate Changes

- Prior law imposed a graduated series of corporate tax rates, as follows:
  - 15% on the first $50,000 of taxable income
  - 25% on the next $25,000 of taxable income
  - 34% up to $10 million of taxable income
  - 35% on taxable income in excess of $10 million
  - Additional taxes imposed to phase out the effects of lower tax rates

- Corporate tax rate is reduced to a single 21% rate, for taxable years beginning after December 31, 2017

- Section 15 authorizes blended tax rates for taxable (fiscal) years that include part of calendar 2017 and part of calendar 2018
## Dividends-Received Deduction Adjustments

<table>
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<tr>
<th>Stock Ownership</th>
<th>Prior Percentage</th>
<th>Prior Effective Tax Rate</th>
<th>New Percentage</th>
<th>New Effective Tax Rate</th>
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<td>70%</td>
<td>10.5%</td>
<td>50%</td>
<td>10.5%</td>
</tr>
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</table>
Other Collateral Consequences

- Certain other taxes are tied to the maximum corporate tax rate:
  - Personal holding company taxes
  - Accumulated earnings taxes
  - S corporation built-in gains taxes
  - S corporation taxes on excess net investment income
  - Unrelated business income tax (for certain organizations)
- No separate tax rate is provided for personal service corporations (as had been proposed in the House bill)
- Corporate “interest charge” provisions, e.g., installment method deferrals, income forecast method, and long-term contract method, are all tied to the maximum section 11 tax rate
- ASC 740 - Enactment date, December 22, 2017
  - One time revaluation for deferred tax assets and liabilities
Net Operating Loss Limitations

Net operating loss ("NOL") allowances are modified in significant ways, effective for NOLs arising in taxable years ending after December 31, 2017:

- No NOL may be carried back (except for certain farming losses)
- NOLs may be carried forward indefinitely
- NOLs may offset no more than 80% of taxable income, computed without regard to the NOL deduction

NOLs arising in taxable years ending before January 1, 2018, are subject to the provisions of prior law:

- NOLs may be carried back for two taxable years
- NOLs may be carried forward up to 20 taxable years
- NOLs may offset all of the available taxable income, computed without regard to the NOL deduction (subject to other limitations, such as section 382)
Corporate Alternative Minimum Tax Repeal

- The corporate alternative minimum tax ("AMT") is repealed, effective for taxable years beginning after December 31, 2017.

- Existing AMT credits may offset regular tax and/or refunded, as follows:
  - The tentative minimum tax ("TMT") is set to zero for subsequent years.
  - AMT credits may be used to reduce regular tax to the level of TMT, i.e., zero.
  - An additional refundable amount seeks to refund all AMT credits in stages, in taxable years beginning in 2018 through 2021 (fully refunded by 2021).

- The provision does not eliminate all "business" AMT, as individuals will have to take into account their share of AMT adjustments and preferences from sole proprietorships, disregarded entities, and pass-through entities.
Research and Experimental Expenditures

While no change was made to the research credit, several changes indirectly affect the credit beginning in 2018:

- A decline in the corporate tax rate makes the credit more valuable.
- The repeal of the corporate AMT effectively increases the limitation on some corporate taxpayer’s use of the credit.
- The 80% limitation on the offset of NOL carryovers against taxable income may permit the use of credits even if NOLs are not fully absorbed.

For taxable years beginning after December 31, 2021, research expenditures (including software development costs) must be capitalized and amortized over five years (15 years in the case of the costs of research conducted outside of the United States).
Temporary or Permanent?

- Most of the corporate and business provisions are permanent, with the following exceptions:
  - The 100% bonus (expensing provisions);
  - The ability to add back depreciation, amortization, and depletion in arriving at adjusted taxable income under section 163(j); and
  - The deduction relating to qualified business income.

- Most of the individual provisions expire after 2025.

- Choice of entity
Pass-through Entities Update
Pass-Through Entity Taxation Background

- Old Law
  - Self-employment tax for partnerships and sole proprietorships
  - Reasonable compensation requirements for S corporation owners
  - Income taxed at individual’s applicable tax rate

- Legislative Process
  - Initial House bill labor and capital allocation
  - Initial Senate bill provided a flat percentage deduction for all pass-through business income
  - Final Conference Agreement resulted in a system similar to the Senate bill

- Conference Agreement definition of “trade or business”
Treatment of Qualified Business Income

- Taxpayers other than corporations are generally eligible to claim a deduction equal to the sum of:
  - The lesser of (A) the taxpayer’s “combined qualified business income amount” or (B) 20% of the excess of the taxpayer’s taxable income over capital gain plus qualified cooperative dividends, plus
  - The lesser of (A) 20% of the aggregate amount of qualified cooperative dividends or (B) the taxpayer’s taxable income (reduced by net capital gains).

- A taxpayer’s combined qualified business income amount is equal to the sum of (1) 20% of the taxpayer qualified business income (“QBI”) with respect to each qualified trade or business plus (2) 20% of the aggregate amount of qualified real estate investment trust dividends and qualified publicly traded partnership income.
Treatment of Qualified Business Income—Limitations (Cont’d)

- The deduction attributable to 20% of the taxpayer’s QBI cannot exceed the greater of (A) 50% of W-2 wages paid with respect to the QBI or (B) the sum of 25% of W-2 wages plus 2½% of the unadjusted basis of qualified property.

- Qualified property includes depreciable tangible property that (i) is held by and available for use in the trade or business at the close of the taxable year, (ii) is used during the year in the production of QBI, and (iii) has a remaining depreciable period.

- The term “depreciable period” means the later of ten years from the original placed in-service date or the last day of the last full year in the applicable recovery period determined under section 168.

- The W-2 wages or W-2 wages plus capital limitation does not apply to taxpayers with taxable income not exceeding $315,000 (joint filers) or $157,500 (other filers). The limitation is phased in for taxpayers with taxable income exceeding these amounts over ranges of $100,000 and $50,000.
Qualified Business Income (QBI) - Specified Services

- Specified Service Trade or Businesses
  - Health
  - Law
  - Accounting
  - Actuarial Science
  - Performing Arts
  - Consulting
  - Athletics
  - Financial Services
  - Brokerage Services
  - Any other business where the principal asset is the reputation or skill of one or more employees

- No QBI deduction for these businesses for married filing joint taxpayers with over $415,000 of taxable income ($207,500 for other types of filers)
Qualified Business Income Examples

- John owns an S corporation from which he gets $80,000 of wages and $255,000 of qualified business income
  - Assume John’s S corporation pays a total of $80,000 in wages and has $500,000 of qualifying property
- John is married and files a joint return with his wife, Erin
- If Erin has no income their deduction under Sec 199A would be $51,000
  - This is true whether John is in a specified service business or not
- If Erin had $54,000 of wages, and
  - John is not in a specified service business their deduction would be $45,500
  - John is in a specified service business their deduction would be $22,750
- If Erin had $108,000 of wages and
  - John is not in a specified service business their deduction would be $40,000
  - John is in a specified service business their deduction would be $0
Overall Limitation on Non-Corporate Business Losses

- Taxpayers other than corporations are currently subject to three limitations on their losses from pass-through businesses, applied in the following order:
  - Basis limitations (section 1366(d) or 704(d));
  - At-risk limitations (section 465); and
  - Passive loss limitations (section 469).

- For all taxpayers other than corporations, “net business losses” in excess of a threshold amount will not be deducted. Provisions are applied after the foregoing three limitations are applied.

- Threshold limitations are as follows:
  - $500,000 for married filing jointly, and
  - $250,000 for all other taxpayers.

- Losses disallowed under this provision are carried forward in the same manner as net operating losses.
Interest Expense Deduction Limitations

- For taxable years beginning after December 31, 2017, the deduction for business interest shall not exceed the sum of—
  - The business interest income for the taxable year;
  - 30% of the adjusted taxable income for the taxable year; and
  - The “floor plan financing interest” of the taxpayer for the taxable year.

- Interest disallowed by virtue of this limitation is carried forward indefinitely.

- Adjusted taxable income is determined without regard to—
  - Any non-business income, deduction, gain, or loss of the taxpayer;
  - Business interest expense or income;
  - Any net operating loss deduction;
  - Any deduction under section 199A (for qualified business income); and
  - For taxable years beginning before January 1, 2022, any deduction for depreciation, amortization, or depletion.
Interest Expense Deduction Limitations (Cont’d)

Limitations do not apply to the following:
- The trade or business of being an employee;
- Any electing real property trade or business;
- Any electing farming business; and
- Most “utility” services (electricity, water, sewage disposal, gas, or steam).

Electing real property trades or businesses and electing farming businesses give up their right to use full “expensing” on longer-lived categories of fixed assets.

Exceptions are also provided for any business (other than a tax shelter) that would fall below a three-year average annual gross receipts limitation of $25 million.
Temporary Expensing of Capital Expenditures

- Section 168(k)(4) “bonus” depreciation increased to 100% for property with a recovery period of less than 20 years, acquired and placed in service—
  - After September 27, 2017; and
  - Before January 1, 2023; or
  - Before January 1, 2024, in the case of certain property with long production periods.

- After 2022, the bonus depreciation percentage is reduced to zero in 20% increments, *i.e.*, 80% for 2023, 60% for 2024, 40% for 2025, and 20% for 2026.

- Bonus depreciation is not generally available for businesses exempt from the interest expense limitations, *i.e.*, electing real property trades or businesses, electing farming businesses, businesses with floor plan financing, and providers of utility services.
Business Asset Sales/Ordinary Gain Potential

- Taxpayers recognize long-term capital gains from the sale or exchange of a capital asset held for more than one year.

- Section 1221 defines a capital asset as any property that is not identified in the statute, including:
  - Inventories and other property held primarily for sale to customers in the ordinary course of a trade or business;
  - Property used in a trade or business, of a character subject to the allowance for depreciation, and real property used in a trade or business; and
  - Accounts or notes receivable acquired in the ordinary course of a trade or business.

- A fourth exclusion was expanded to apply to “a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property” created by the taxpayer’s efforts or acquired from the creator in a tax-free transaction, effective for dispositions after December 31, 2017.
Selected Small Business Provisions

Several favorable limitations are provided for small businesses, defined as businesses with three-year average annual gross receipts not exceeding $25 million:

- The ability to use the cash receipts and disbursements method of accounting (section 448);
- The ability to treat inventories as non-incidental materials and supplies (section 471);
- Exemption from the interest limitation rules (section 163(j));
- Exemption from the uniform capitalization rules (section 263A); and
- Exemption from the portions of the long-term contract rules, principally the requirement to use the percentage-of-completion method (section 460).
Selected Other Business/Investment Provisions

- The deduction for domestic production activities is repealed, effective for taxable years beginning after December 31, 2017.
- The section 45C orphan drug credit rate is reduced from 50% to 25%, effective for taxable years beginning after December 31, 2017.
- Section 1031 like-kind exchange treatment will be limited to real property, effective for dispositions completed after December 31, 2017 (with exceptions for exchanges where one leg was completed on or before that date).
- For taxable years beginning after December 31, 2021, the “carried interest” concerns are addressed by requiring a minimum three-year holding period requirement as a condition of receiving long-term capital gain treatment with respect to an “applicable partnership interest” transferred in connection with the performance of services.
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