

# UNDERSTANDING AND MAKING THE NEW SECTION 646 ELECTION FOR ALASKA NATIVE SETTLEMENT TRUSTS

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*This Article examines The Economic Growth and Tax Relief Reconciliation Act of 2001 and the effect it may have on Alaska Native settlement trusts. The Article initially discusses the nature of Alaska Native settlement trusts and the key tax issues relating to the trusts that have arisen under present law. The Article next examines in depth the extent to which the 2001 Act adequately addresses these key issues. The Article then summarizes the advantages and disadvantages of the 2001 Act and concludes that the Act is a major step forward in finally realizing the potential of settlement trusts for the Alaska Native community.*

## I. INTRODUCTION

The Economic Growth and Tax Relief Reconciliation Act of 2001<sup>1</sup> (“2001 Tax Act”) adds a new elective tax regime to the Internal Revenue Code (the “I.R.C.”). This new elective tax regime permits Alaska Na-

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1. Pub. L. No. 107-16, 115 Stat. 38 (2001) (to be codified as amended in scattered sections of 26 U.S.C.).

tive settlement trusts to be taxed in a manner different from the normal fashion under Subchapter J of the I.R.C.<sup>2</sup> Under this elective tax regime, a settlement trust will pay tax at the same rate as the lowest rate identified in the I.R.C. for an unmarried individual, and beneficiaries will not pay tax on distributions of an electing trust's taxable income. Contributions by an Alaska Native corporation to an electing trust will not be deemed distributions to the corporation's shareholders, and electing trusts are excused from the duty to send annual Form K-1s to the beneficiaries and the Internal Revenue Service. This new tax regime is immediately available for existing settlement trusts, retroactive to January 1, 2001.<sup>3</sup>

The author believes the new legislation offers solutions to most of the tax issues that have arisen in recent years concerning Alaska Native settlement trusts, and predicts the new legislation will provide an incentive both for creating more settlement trusts and for contributing more assets to existing trusts.

This article proceeds in eight basic parts including an introduction and a conclusion. Part II is an overview of the federal and state non-tax law governing Alaska Native settlement trusts, providing a context in which settlement trusts can be better understood. Parts III and IV discuss the tax law applicable to settlement trusts that fail to elect the new legislation and the major problems existing law poses. Part V discusses the consequences of an election under the new law. Part VI summarizes the anticipated advantages and disadvantages of the election. Immediately preceding the conclusion, Part VII offers some observations on how the new elective regime can be improved.

## II. ALASKA NATIVE CLAIMS SETTLEMENT ACT ("ANCSA") SETTLEMENT TRUSTS

### A. ANCSA

The Alaska Native Claims Settlement Act<sup>4</sup> established over 200 Native corporations to receive just under a billion dollars<sup>5</sup> and 44 million

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2. See generally, I.R.C. §§ 641-691 (1994), together with the regular tax rates of I.R.C. § 1(e) and the alternative minimum tax provisions of I.R.C. §§ 55-59. (Note: the date reference to the I.R.C. is to the last bound volume of the U.S. Code. The sections referred to in this article, however, incorporate all amendments through 2001.)

3. For a settlement trust that was in existence when the legislation was signed into law, or one that comes into existence during 2001, the election *must* be made for the 2001 year or else the opportunity to elect the new legislation is forever lost. Since all settlement trusts are calendar year taxpayers, the election is necessarily retroactive to January 1, 2001.

4. Pub. L. No. 92-203, 85 Stat. 688 (1971) (codified as amended at 43 U.S.C. §§ 1601-1629 (1994)) [citations herein are to the section of ANCSA and the parallel code

acres<sup>6</sup> in actual settlement of Alaska Native aboriginal claims. The hope when ANCSA was passed in 1971 was that requiring the corporate form would allow Alaska Natives to transition smoothly from a subsistence economy into a cash-based economy, thereby avoiding many of the problems of the reservation system encountered by indigenous groups in the lower 48 states and ending paternalism in the federal government's relationship with Alaska Natives.<sup>7</sup>

Unfortunately, the corporate form has often proved unsuitable for addressing the unique needs of Alaska Natives.<sup>8</sup> Congress has repeatedly amended ANCSA and other federal laws to make the settlement more workable.<sup>9</sup> In 1988, Congress added section 39 authorizing Alaska Na-

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cite].

5. ANCSA § 6 (codified as amended at 43 U.S.C. § 1605 (1994)).

6. ANCSA §§ 12, 14 (codified as amended at 43 U.S.C. §§ 1611, 1613); *see* S. REP. NO. 100-201, at 19-20 (1987), *reprinted in* 1987 U.S.C.C.A.N. 3269, 3270.

7. ANCSA § 2(b) (codified as amended at 43 U.S.C. § 1601(b)); *Alaska v. Native Village of Venetie Tribal Gov't.*, 522 U.S. 520, 534 (1998).

8. S. REP. NO. 100-201, at 20-21 (1987), *reprinted in* 1987 U.S.C.C.A.N. 3269, 3270-3271; 133 CONG. REC. H11933 (daily ed. Dec. 21, 1987) (House explanatory statement), *reprinted in* 1987 U.S.C.C.A.N. 3299, 3307 [hereinafter House Explanatory Statement].

9. Indeed, ANCSA has been amended more than 20 times in the 30 years since its enactment in 1971. *See*, Act of Jan. 2, 1976, Pub. L. No. 94-204, 89 Stat. 1145 (amending ANCSA); Fiscal Year Adjustment Act, Pub. L. No. 94-273, sec. 38, § 6(a)(1)(D), § 6(a)(1)(E), 90 Stat. 375, 380-81 (1976); Act of Oct. 4, 1976, Pub. L. No. 94-456, 90 Stat. 1934 (amending ANCSA); Act of Nov. 15, 1977, Pub. L. No. 95-178, 91 Stat. 1369 (amending ANCSA); Act of Aug. 14, 1979, Pub. L. No. 96-55, 93 Stat. 386 (Nenana, Alaska, land conveyance); Act of July 17, 1980, Pub. L. No. 96-311, 94 Stat. 947 (time extension for Cook Inlet land exchange); Alaska National Interest Lands Conservation Act, Pub. L. No. 96-487, secs. 1401-37, 94 Stat. 2371, 2491-549 (1980); Alaska Railroad Transfer Act of 1982, Pub. L. No. 97-468, secs. 601-16, 96 Stat. 2543, 2556-78 (1983); Act of Oct. 18, 1986, Pub. L. No. 99-500, 100 Stat. 1783; Act of Oct. 30, 1986, Pub. L. No. 99-591, 100 Stat. 3341; ANCSA Amendments of 1987, Pub. L. No. 100-241, 101 Stat. 1788 (1988); Act of Nov. 5, 1990, Pub. L. No. 101-511, 104 Stat. 1856 (Department of Defense Appropriations Act); Act of Nov. 13, 1991, Pub. L. No. 102-154, 105 Stat. 990 (Department of Interior and Related Agencies Appropriations Act); Alaska Land Status Technical Corrections Act of 1992, Pub. L. No. 102-415, 106 Stat. 2112; Act of Oct. 24, 1992, Pub. L. No. 102-497, 106 Stat. 3255, 3260 (amending certain Federal Indian statutes); Resolution Trust Corporation Completion Act, Pub. L. No. 103-204, sec. 32(b), § 12(b)(7)(vii), 107 Stat. 2369, 2413 (1993); Act of May 18, 1995, Pub. L. No. 104-10, 109 Stat. 15 (amending ANCSA); Act of Nov. 2, 1995, Pub. L. No. 104-42, 109 Stat. 353 (amending ANCSA); Act of Oct. 21, 1998, Pub. L. No. 105-276, sec. 432, 112 Stat. 2461, 2516-18 (amending ANCSA); ANCSA Land Bank Protection Act of 1998, Pub. L. No. 105-333, 112 Stat. 3129; Act of May 2, 2000, Pub. L. No. 106-194, 114 Stat. 239 (amending ANCSA); Kake Tribal Corporation Land Transfer Act, Pub. L. No. 106-283, 114 Stat. 867 (2000); Indian Tribal Justice Technical and Legal Assistance

tive corporations to establish one or more “settlement trusts” through which health, education and welfare benefits could be provided to their respective shareholders.<sup>10</sup>

### B. Settlement Trusts—In General

A settlement trust is organized under Alaska state law<sup>11</sup> and is legally distinct from the Native corporation that establishes the trust.<sup>12</sup> It may not operate as a business<sup>13</sup> and is required to invest its assets passively to generate the funds it needs.<sup>14</sup> The governance of the trust is outlined in the document that creates the trust, which is essentially a contract between the sponsoring Native corporation and the trustees.<sup>15</sup> Because it is a legal entity separate from the sponsoring Native corporation, the trust is responsible under Alaska law for filing its own income tax returns, reporting to its beneficiaries, investing its assets, paying its expenses and making distributions to the beneficiaries.<sup>16</sup>

### C. Benefits/Beneficiaries

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.”<sup>17</sup>

A wide spectrum of benefits can be provided through a settlement trust, and existing trusts reflect this diversity. Prior to May 2000, the beneficiaries of the settlement trust were required to be shareholders of the sponsoring Native corporation,<sup>18</sup> although case authority implicitly indicated that not every shareholder had to be a beneficiary.<sup>19</sup> In May 2000, ANCSA was amended to allow settlement trusts to benefit “share-

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Act of 2000, Pub. L. No. 106-559, 114 Stat. 2778, 2782-83.

10. ANCSA Amendments of 1987, Pub. L. No. 100-241, sec. 10, 101 Stat. 1788, 1804-06 (1988). This article refers to a corporation that has established a settlement trust as a “sponsoring Native corporation.”

11. ANCSA § 39(a)(1)(A) (codified as amended at 43 U.S.C. § 1629e(a)(1)(A)).

12. ANCSA § 39(c)(5) (codified as amended at 43 U.S.C. § 1629e(c)(5)).

13. ANCSA § 39(b)(1)(A) (codified as amended at 43 U.S.C. § 1629e(b)(1)(A)).

14. House Explanatory Statement, *supra* note 8, at H11933, *reprinted in* 1987 U.S.C.C.A.N. 3299, 3307.

15. *Id.* at H11936-37, *reprinted in* 1987 U.S.C.C.A.N. 3299, 3308.

16. ALASKA STAT. §§ 13.36.070, 13.36.109 (Michie 2000).

17. ANCSA § 39(b)(1) (codified as amended at 43 U.S.C. § 1629e(b)(1)); House Explanatory Statement, *supra* note 8, at H11936, *reprinted in* 1987 U.S.C.C.A.N. 3299, 3307.

18. ANCSA § 3(t) (codified as amended at 43 U.S.C. 1602(t)) (prior to amendment by Act of May 2, 2000, Pub. L. No. 106-94, sec. 3, 114 Stat. 239, 243).

19. *Broad v. Sealaska Corp.*, 85 F.3d 422, 428 (9th Cir. 1996).

holders, Natives, and descendants of Natives.”<sup>20</sup> The import of this amendment is that a settlement trust can be established to benefit Natives or descendants of Natives who are not shareholders of the sponsoring Native corporation. Under ANCSA the term “Native” generally requires that persons have at least one-quarter Native blood,<sup>21</sup> while the term “descendant of a Native” means a lineal descendant of a Native.<sup>22</sup>

#### D. Establishing the Trust

ANCSA provides a two-step procedure under which a settlement trust is to become effective. First, the board of directors of the Native corporation must adopt a resolution establishing the settlement trust, subject to a vote of the shareholders.<sup>23</sup> Second, an absolute majority (i.e., more than 50% of all outstanding voting shares of the Native corporation) must approve the trust as an ANCSA settlement trust.<sup>24</sup>

#### E. Funding the Trust

Once the shareholders approve a trust as an ANCSA settlement trust, the board of directors of the Native corporation decides whether to make contributions to the trust.<sup>25</sup> Accordingly, the shareholders do not generally approve specific contributions to the settlement trust.<sup>26</sup> The only exception is if a contribution is “all or substantially all” of the assets of the sponsoring Native corporation. In this circumstance, ANCSA requires that the Native shareholders approve the asset transfer.<sup>27</sup> ANCSA does not specify minimum or maximum contributions to the trust, although the proxy materials sent to shareholders relating to the vote establishing the trust should normally include the anticipated funding plan.<sup>28</sup> The contributions to the trust may be either in cash or in kind, although a significant tax issue exists if appreciated assets are being contributed.<sup>29</sup>

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20. Act of May 2, 2000, Pub. L. No. 106-194, sec. 3, 114 Stat. 239, 243.

21. ANCSA § 3(b) (codified as amended at 43 U.S.C. § 1602(b)).

22. ANCSA § 3(r) (codified as amended at 43 U.S.C. § 1602(r)).

23. ANCSA § 36(b)(1) (codified as amended at 43 U.S.C. § 1629b(b)(1)).

24. ANCSA § 36(d) (codified as amended at 43 U.S.C. § 1629b(d)).

25. ANCSA § 36(a)(4) (codified as amended at 43 U.S.C. § 1629b(a)(4)).

26. ANCSA § 39(c)(7) (codified as amended at 43 U.S.C. § 1629e(c)(7)).

27. ANCSA § 39(a)(1)(B) (codified as amended at 43 U.S.C. § 1629e(a)(1)(B)).

28. ANCSA § 36(b) (codified as amended at 43 U.S.C. § 1629b(b)). *See* *Brown v. Ward*, 593 P.2d 247 (Alaska 1979); ALASKA ADMIN. CODE tit. 3, §§ 08.355-08.365 (2001) (discussing disclosure duties imposed on proxy solicitations with regard to votes by ANCSA shareholders); *see also* *Sierra v. Goldbelt, Inc.*, 25 P.3d 697, 703-04 (Alaska 2001).

29. The corporation will have to recognize any appreciation in the value of its assets over its tax basis as taxable gain. I.R.C. § 311(b) (1994).

#### F. Managing the Trust

Just as the business and affairs of a Native corporation are run by the corporation's officers under the guidance of the board of directors, the business and affairs of the settlement trust are run by the officers of the settlement trust under the guidance of its trustees. ANCSA requires that the trustees be individuals, but does not impose any other qualifications.<sup>30</sup>

The sponsoring Native corporation has the "exclusive authority" to appoint and remove the trustees.<sup>31</sup> As a practical matter, initial trustees and a method for choosing successor trustees will be designated in the Trust Agreement. No limit is imposed on the number of trustees that can be selected. Most settlement trusts have been established with the sponsoring Native corporation's Directors serving coterminously as the trustees of the settlement trust. This allows maximum coordination of financial planning between the entities.

#### G. Prohibition Against Business Activities

ANCSA provides that a settlement trust *cannot* engage in the operation of a business<sup>32</sup> and prohibits the contribution of timber assets<sup>33</sup> that are subject to revenue sharing under section 7(i) of ANCSA.<sup>34</sup> The "prudent person" rule imposed by Alaska law governs investment of the trust's assets.<sup>35</sup> That is, the trustees are to invest the settlement trust's assets in the same manner as would a prudent person. The trust agreement itself may contain other restrictions on investments. An example would be a prohibition on loans to individuals. The trustees often will establish investment policies and guidelines that further restrict investments.

#### H. Authority of Trustees to Make Tax Elections

Alaska law provides that "[w]ithout authorization by a court, a trustee may exercise the powers conferred by the terms of the trust . . . ."<sup>36</sup> A well-drafted trust agreement will include language expressly authorizing tax elections.<sup>37</sup> Even in the absence of express language in the trust

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30. ANCSA § 39(b)(2) (codified as amended at 43 U.S.C. § 1629e(b)(2)).

31. *Id.*

32. ANCSA § 39(b)(1)(A) (codified as amended at 43 U.S.C. § 1629e(b)(1)(A)).

33. ANCSA § 39(c)(2) (codified as amended at 43 U.S.C. § 1629e(c)(2)).

34. ANCSA § 7(i) (codified as amended at 43 U.S.C. § 1606(i)).

35. ALASKA STAT. §§ 13.36.225 - .290 (Michie 2000).

36. *Id.* § 13.36.107(a).

37. Sample language might read: "[t]o make any election permitted by tax law which is deemed to be in the best interest of the Trust, [Name of sponsoring Native corporation], or the Beneficiaries."

agreement, the powers granted by Alaska law to trustees should be broad enough to authorize the election of the new tax regime. Alaska Statutes section 13.36.070, for example, establishes that, except as may be specifically designated, the general duty of the trustee to administer a trust expeditiously in favor of the beneficiaries is not altered by Alaska law.<sup>38</sup> Perhaps more to the point, Alaska Statutes section 13.36.109 indicates that except as is otherwise expressly designated in Alaska Statutes chapter 13.36, and in addition to the powers set forth in the trust agreement, “a trustee may perform all actions necessary to accomplish the proper management, investment, and distribution of the trust property . . . .”<sup>39</sup>

However, Alaska law also cautions that “[t]he grant of a power to a trustee, whether under the terms of the trust, this chapter [Alaska Statutes chapter 13.36], or a court, does not alone govern the exercise of the power.”<sup>40</sup> What this means is that the trustees must, in good faith and after exercising due diligence, decide whether making an election under the 2001 Tax Act is in the best interest of the trust and its beneficiaries, taken as a whole.<sup>41</sup>

#### I. Existing Settlement Trusts

As of December 31, 1999,<sup>42</sup> Alaska Native corporations had established 18 settlement trusts. Twelve of these trusts paid *pro rata* income benefits, one was a holding entity for cutover land, one provided just educational benefits, one provided combined educational and funeral benefits, and three provided elders’ benefits.<sup>43</sup> In the aggregate, these trusts held approximately \$300 million in assets.<sup>44</sup> Not every Native corporation has established a settlement trust, but those that have established trusts have placed substantial assets in them. The largest of these settlement trusts had approximately \$60 million in assets as of December 31, 1999.<sup>45</sup>

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38. ALASKA STAT. § 13.36.070 (Michie 2000).

39. *Id.* § 13.36.109.

40. *Id.* § 13.36.107(c).

41. *Id.* § 13.36.107.

42. This is the most recent date for which this information is available.

43. These are not the only benefits a settlement trust may provide. For example, the legislative history indicates that a settlement trust may provide health benefits (in various forms). House Explanatory Statement, *supra* note 8, at H11933, *reprinted in* 1987 U.S.C.C.A.N. 3299, 3307.

44. Data on file with the author.

45. Data on file with the author.

## III. TAX CHARACTERISTICS OF PRESENT LAW

## A. Taxation of Settlement Trusts

Assuming a settlement trust is properly characterized as a trust for tax purposes,<sup>46</sup> and further assuming the trust is not a grantor trust (the income of which is taxable to the grantor, i.e., the sponsoring Native corporation),<sup>47</sup> a settlement trust is subject to a steeply graduated federal income tax on its ordinary income (e.g., dividends and interest) and its short term capital gains (gains on assets held for less than 12 months) topping out at 39.6%,<sup>48</sup> while its net long-term capital gains (capital gain on assets held for more than 12 months) are taxed at 20%.<sup>49</sup>

The settlement trust's taxable income is computed on the basis of the calendar year<sup>50</sup> and otherwise in the same manner as an individual's taxable income,<sup>51</sup> with certain adjustments specified in Subchapter J of the I.R.C.<sup>52</sup> These adjustments include a deduction for distributions, up to certain limits.<sup>53</sup> The corollary of the distribution deduction by the trust is inclusion by the beneficiaries in the aggregate of an amount equal to the deduction.<sup>54</sup> In general, a trust that distributes an amount that equals or exceeds its taxable income in a given year will not be subject to an income tax liability, while its beneficiaries will be to the extent of the distributed taxable income of the trust. The scheme of Subchapter J, therefore, is one level of tax on distributed income, payable by the beneficiaries.

A trust may also be subject to an alternative minimum tax<sup>55</sup> if it escapes or substantially avoids the regular section 1(e) tax through the use of certain deductions (known as items of tax preference).

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46. I.R.C. § 7701 (1994) and applicable regulations.

47. *Id.* §§ 671-78.

48. *Id.* § 1(e).

49. *Id.* § 1(h)(1)(C).

50. *Id.* § 644(a).

51. *Id.* § 641(b).

52. *Id.* §§ 641-92.

53. *Id.* §§ 651, 661.

54. The Internal Revenue Code draws a distinction between trusts that only distribute their "income" (as used in a state law sense rather than in a Tax code sense, *see* I.R.C. § 643(b)), and trusts that may either accumulate income or distribute principal. I.R.C. § 643(b). The trust deduction and beneficiary inclusion rules for the former type of trust are contained in I.R.C. sections 651 and 652, while the parallel provisions for the latter type of trust are contained in sections 661 and 662. The differences between these sections are not directly relevant to this article. Future citations herein are simply parallel cites, e.g., "I.R.C. §§ 652(a), 662(a)" to indicate the beneficiary inclusion rules.

55. I.R.C. §§ 55-59.

A trust that distributes appreciated property in kind to its beneficiaries may make an election under I.R.C. section 643(e) to recognize the appreciation as gain. If this election is made, the beneficiaries will take a basis in the distributed property equal to the property's fair market value. If no section 643(e) election is made, there is no gain recognition to the trust and the beneficiaries simply succeed to the trust's basis. The beneficiaries will then presumably recognize the deferred gain when they sell the appreciated property.<sup>56</sup>

The IRS has issued a total of 22 private letter rulings<sup>57</sup> concerning various aspects of the application of the federal tax law to Alaska Native settlement trusts.<sup>58</sup>

#### B. Contributions to Settlement Trusts

According to the IRS, all contributions by a Native corporation to a settlement trust produce an economic benefit to the corporation's shareholders and are thus constructive distributions to the shareholders.<sup>59</sup>

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56. As a practical matter, distributions of appreciated property by ANCSA settlement trusts will be rare if they occur at all, given the large number of beneficiaries of any given trust. The thought of distributing 1000 shares of corporate stock in kind to 1000 beneficiaries seems overwhelmingly complex given the ease with which the same 1000 shares could be sold and cash distributed.

57. Priv. Ltr. Rul. 2001-12-7012 (Apr. 3, 2001); Priv. Ltr. Rul. 1999-17-036 (Jan. 28, 1999); Priv. Ltr. Rul. 98-39-037 (July 1, 1998); Priv. Ltr. Rul. 98-24-014 (Mar. 10, 1998); Priv. Ltr. Rul. 98-24-002 (Feb. 28, 1998); Priv. Ltr. Rul. 97-27-007 (Mar. 26, 1997); Priv. Ltr. Rul. 97-13-016 (Dec. 24, 1996); Priv. Ltr. Rul. 97-13-015 (Dec. 24, 1996); Priv. Ltr. Rul. 97-13-011 (Dec. 19, 1996); Priv. Ltr. Rul. 96-44-039 (July 30, 1996); Priv. Ltr. Rul. 96-31-014 (Apr. 30, 1996); Priv. Ltr. Rul. 96-28-009 (Apr. 11, 1996); Priv. Ltr. Rul. 95-22-051 (Mar. 8, 1995); Priv. Ltr. Rul. 95-16-023 (Jan. 17, 1995); Priv. Ltr. Rul. 95-16-022 (Jan. 17, 1995); Priv. Ltr. Rul. 95-02-011 (Sept. 29, 1994); Priv. Ltr. Rul. 94-52-019 (Sept. 28, 1994); Priv. Ltr. Rul. 94-33-021 (May 19, 1994); Priv. Ltr. Rul. 93-29-026 (Apr. 28, 1993); Priv. Ltr. Rul. 93-26-019 (Mar. 31, 1993); Priv. Ltr. Rul. 91-19-037 (Feb. 8, 1991); Priv. Ltr. Rul. 89-47-054 (Aug. 31, 1989).

58. There is no precise correlation between the number of trusts actually established and the number of rulings issued. Some established trusts did not obtain an IRS ruling and some established trusts have obtained more than one. Moreover, some trusts that were issued rulings have never been implemented.

59. The IRS has repeatedly taken this position in its private letter rulings since 1991, citing *Sproull v. Comm'r.*, 16 T.C. 244 (1951), Rev. Rul. 67-203, 1967-1 C.B. 105, and *U.S. v. Drescher*, 179 F.2d 863 (2d Cir. 1950), as authority. A contrary view exists: the transfer to the settlement trust is akin to a transaction where the shareholder's investment is slightly restructured and then continued in this different form without cash being available to the taxpayer. In such cases, the I.R.C. generally does not treat the restructuring as an event requiring income recognition. See, e.g., I.R.C. § 1031 (like kind exchanges); I.R.C. § 1032 (exchange of stock for property); I.R.C. § 1033 (involuntary

These constructive distributions are taxable to shareholders if the Native corporation has either current or accumulated earnings and profits in the year of distribution.<sup>60</sup> Since the shareholders never receive anything tangible from the contribution, this taxable income from the deemed distribution is “phantom income” to them.

If there are no current or accumulated earnings and profits, the shareholder’s basis in his or her stock is reduced,<sup>61</sup> if a given shareholder does not have adequate basis in his or her stock to “absorb” the deemed distribution, the amount not protected by basis is taxable as gain from the sale of that stock.<sup>62</sup>

The IRS has repeatedly and uniformly ruled that contributions to a settlement trust are not income to that trust.<sup>63</sup>

A hidden trap exists if appreciated property<sup>64</sup> is contributed by the Native corporation to a settlement trust. Since the IRS’s view is that this property is deemed to be distributed to the shareholders, I.R.C. section 311(b) supposedly applies to require the corporation to recognize the appreciation. Further compounding the situation, this gain increases current year earnings and profits, potentially increasing the tax burden to the shareholders from the deemed distribution.

No Native corporation to date has challenged the IRS’s view that contributions to a settlement trust are deemed distributions. Instead, tax planning for contributions has centered around (1) monitoring the Native corporation’s earnings and profits so that there are little, if any, current or accumulated earnings and profits in a contribution year, or (2) making the settlement trust a grantor trust so that there is no transfer from the Native corporation for tax purposes.

### C. Taxation of Beneficiaries

Trust distributions are taxable to beneficiaries to the extent of the trust’s distributable net income, and such income retains the same characteristics as it had in the hands of the trust.<sup>65</sup> Beneficiaries are taxed on trust distributions at whatever their rate would be for that type of income. It can be anticipated that, taking the beneficiary population as a whole, beneficiaries will pay tax at a rate of 15% to 18% on the taxable

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conversions); I.R.C. § 1036 (exchange of stock for stock of same corporation).

60. I.R.C. § 301(c)(1); *see* I.R.C. § 312 (addressing the computation of earnings and profits).

61. *Id.* § 301(c)(2).

62. *Id.* § 301(c)(3).

63. *See, e.g.*, Priv. Ltr. Rul. 98-24-014 (Mar. 10, 1998); Priv. Ltr. Rul. 96-44-039 (July 30, 1996); Priv. Ltr. Rul. 93-29-026 (Apr. 28, 1993).

64. Appreciated property is property for which the fair market value exceeds the tax basis.

65. I.R.C. §§ 652(a), 662(b).

income they receive from a settlement trust even though some of it may be ordinary income, short term capital gain, or even long term capital gain.<sup>66</sup>

If a trust distributes amounts that are in excess of its distributable net income in a given year, the excess distributions are tax free to the beneficiaries.<sup>67</sup> No basis reduction is required. Thus, when a trust completely liquidates, the only amount taxable to a beneficiary is the pro rata amount of the current year's income; all other liquidation distributions are tax free to a beneficiary.

As noted above, whether or not the trust makes a section 643(e) election determines whether the trust or the beneficiary will recognize the appreciation as gain if appreciated property is being distributed in kind.<sup>68</sup>

The IRS has ruled twice that a beneficiary may be able to claim the Hope Educational and Lifetime Learning Credits under I.R.C. section 25A relative to taxable distributions by ANCSA settlement trusts, where the benefits are paid directly to educational institutions if those amounts are expended for qualified education purposes.<sup>69</sup>

#### D. Tax Reporting by the Settlement Trust

The trust must file its own tax return on Form 1041 by April 15 of the following year, although this date can be extended to as late as October 15. On or before the due date of the trust's income tax return, the trust must send a Form K-1 to each beneficiary advising how much of the prior year's distribution(s) is taxable to that beneficiary as well as the

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66. The author makes the assumption of a 15% to 18% rate based upon his work over the years in defending Native corporations and their shareholders in IRS audit situations, especially in situations where a particular Native corporation's earnings and profits have been increased from a disallowance of deductions. In such circumstances, the preference of the IRS has been to try to collect an "in lieu of" tax *from the corporation* on the distributions that have been converted into taxable dividends by the corporate level audit result, rather than attempting collection actions against the numerous individual shareholders. To compute the "in lieu of" tax, the IRS attempts to aggregate the various individual rates of the shareholder population to estimate the hypothetical aggregate tax rate to which the distribution would be subject. This hypothetical aggregate tax rate has ranged in the author's experience from a low of 15% to a high of 18%.

67. I.R.C. §§ 652(a), 662(a).

68. *Id.* § 643(e)(3).

69. Priv. Ltr. Rul. 99-17-036 (Jan. 28, 1999); Priv. Ltr. Rul. 98-39-037 (July 1, 1998). The significance of these rulings is that the character of the distribution (educational purposes) "flows out" to the beneficiaries for credit purposes. The issue might not exist if amounts were paid directly to the student, commingled with his or her other funds, and then remitted by the student to the educational institution. However, most ANCSA educational programs are structured with the payments directly to the institution to assure a proper use of the educational funds.

character of that income. The trust must also attach to its own tax return a copy of the Form K-1s sent to beneficiaries. Since some settlement trusts have over 2,000 beneficiaries, requiring the attachment of a separate Form K-1 for each beneficiary makes the trust's tax return quite lengthy. In addition, from the beneficiary's perspective, the Form K-1 is no model of simplicity and can be confusing. By contrast, the Form 1099-DIV, used to report corporate dividends, is much shorter and simpler, and multiple Forms 1099-DIV can be on the same page.

Given the preference of many beneficiaries to file by April 15, rather than to extend the due date of their own tax returns while awaiting tax information from the trust, it has been the practice of many settlement trusts to send their Form K-1s at the same time as corporate Forms 1099-DIV would be sent, i.e., by January 31 of the succeeding year.

#### IV. KEY TAX ISSUES THAT HAVE ARISEN UNDER PRESENT LAW

Five areas of concern have emerged under present tax law that in the author's view have hindered the use of settlement trusts.

The first area of concern is the IRS ruling position that contributions to a settlement trust are deemed distributions to the shareholders. No corporation, Native or non-Native, wants to proceed in a manner that will produce "phantom income" to its owners. Furthermore, even when the corporation's earnings and profits have been monitored so that the deemed distribution is a return of capital under I.R.C. section 301(c)(2) and an immediate tax is avoided,<sup>70</sup> the question of adequately explaining this issue to the shareholders remains. Under applicable IRS regulations, a Form 1099-DIV still must be sent to an individual shareholder when the distribution may be a return of capital under 301(c)(2). This produces a situation where a shareholder receives a Form 1099-DIV telling the shareholder that he or she has received a distribution when in fact no distribution has been received.<sup>71</sup> The shareholder may be left uncertain whether he or she has received everything from the Native corporation that he or she was supposed to receive. By contrast, if a settlement trust is not created and the assets are simply left in corporate solution, there is no deemed distribution, no phantom income, and no explanation problem.

The second area of concern relates to the tax rates applicable to reinvestments by the settlement trust. The 39.6% rate, applicable under present law to reinvested ordinary income and short-term gains, virtually assures that all of this reinvested income will be distributed. It is simply too expensive, from a tax perspective, to do anything else, especially when the anticipated tax rate the beneficiaries will pay is in the 15% to

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70. I.R.C. § 301(c)(2).

71. *See* Treas. Reg. § 1.6042-3(c).

18% range.<sup>72</sup> While a 20% tax on reinvested long-term capital gains is somewhat less draconian than the tax rate on reinvestments of ordinary income, the individual beneficiaries likely will still pay at a lower rate in the aggregate under existing law than will the trust. Moreover, since replacing an outside investment manager will usually mean that all of that manager's investments will be sold so that cash can be transferred to a new manager, a substantial tax rate on sale gains may distort economic efficiency by impeding a decision to change managers. While in theory Native corporations are subject to tax on their reinvestments (at an effective 40% combined federal and Alaska state burden), many ANCSA corporations have large net operating loss carryovers and/or current losses that allow them to avoid tax on their reinvestments.

The third area of concern under present law is that while most Native corporations are able to pay distributions that are returns of basis under I.R.C. section 301(c)(2),<sup>73</sup> so that the corporation's distributions are not currently taxable to the shareholders, all distributions by a settlement trust will usually be taxable because of the way the Subchapter J trust rules work. Since ANCSA shareholders prize their tax-free distributions, this alone provides a very powerful disincentive to establishing a settlement trust to make ongoing distributions.

The fourth area of concern is that present law imposes a paperwork burden on settlement trusts through the Form K-1 reporting requirements, as well as an interpretive problem for beneficiaries. By contrast, use of a Form 1099-DIV is far simpler for beneficiaries.

The fifth area of concern is that contributions of appreciated property to a settlement trust not only require corporate recognition of the gain, but also increase the corporation's earnings and profits by the extent of the gain, so that the taxable portion of the shareholders' phantom distribution is also increased. While this problem can be avoided to some degree by simply selling the appreciated asset and then contributing the proceeds to the trust in a later year, it will not always be desirable or possible to do so. A prime example is land that was conveyed to the corporation under ANCSA. The legislative history of the 1988 amendments to ANCSA clearly indicates that Congress anticipated ANCSA land would be contributed to settlement trusts to afford better protection from creditor claims and unwise sales.<sup>74</sup> However, ANCSA land has not

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72. See *supra* note 66.

73. I.R.C. § 301(c)(2). Tax losses produce negative earnings and profits. ANCSA contains special and favorable rules under which depletion can be computed for tax purposes, and if a Native corporation is engaged in natural resource exploitation, operating losses can result for tax purposes even though there may be positive cash flow from the natural resource activity.

74. S. REP. NO. 100-201, at 19-20 (1987), *reprinted in* 1987 U.S.C.C.A.N. 3269, 3285; House Explanatory Statement, *supra* note 8, at H11933, *reprinted in* 1987

actually been conveyed to settlement trusts on a widespread basis, at least in part due to a concern that the land may have appreciated since it was received from the government. Valuation of remote Alaska land is particularly problematic due to a relative dearth of sales.

These five concerns were the principal driving force behind the six-year effort to obtain more favorable tax treatment for ANCSA settlement trusts. The good news is that the first four of these issues have been solved in large part by the passage of the 2001 Tax Act, and specifically section 671.<sup>75</sup> Only the last problem, that of gain recognition on the contribution of appreciated property, remains a serious hurdle after the 2001 Tax Act.

## V. CONSEQUENCES OF AN ELECTION UNDER THE 2001 TAX ACT

### A. Overview

Section 671 of the 2001 Tax Act<sup>76</sup> is the provision enacted by Congress to address the foregoing problems. The provision originated in the Senate as section 691 of the Restoring Earnings to Lift Individuals and Empower Families (Relief) Act of 2001<sup>77</sup> and survived the conference agreement.<sup>78</sup> As enacted, section 671 has three principal parts. The first part adds section 646 to the I.R.C., detailing the actual election governed by the new tax regime and its principal components. The second part adds a new section 6039H, dealing with information reporting by electing settlement trusts. The last part of section 671 provides effective dates. Of these three parts, the portion adding the actual election, new section 646, is the most complex and lengthy.

The election provision, new I.R.C. section 646, is itself divided into five principal subparts. These subparts describe taxation of an electing trust and its beneficiaries (subsections (a) and (b)), the process of making the election (subsection (c)), taxation of contributions (subsection

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U.S.C.C.A.N. 3299, 3307.

75. 2001 Tax Act, Pub. L. No. 107-16, 115 Stat. 144.

76. § 671, 115 Stat. at 144-48.

77. Undoubtedly due to the rapidity with which the Economic Growth and Tax Relief Reconciliation Act of 2001 became law, there is no separate Senate Report on S. 896. However, there is a Senate Finance Committee Print. See STAFF OF SENATE COMM. ON FINANCE, 107th Cong., TECHNICAL EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MAY 15, 2001 (Comm. Print 2001) [hereinafter SFC Technical Explanation].

78. H.R. CONF. REP. NO. 107-84, at 301-04 (2001) [hereinafter Conference Report]. As there was no counterpart provision in the House bill, most of the language in the Conference Report explaining section 671 is quoted from the SFC Technical Explanation, *supra* note 77.

(d)), taxation of distributions (subsection (e)), and prophylactic rules (subsections (f) and (i)).

#### B. Making the Election

Perhaps the simplest aspect of the section 646 election is the manner in which it is made. Under section 646(b), the election is to be made by attaching a statement<sup>79</sup> to the trust's timely income tax return for the first tax year ending after the effective date of the 2001 Tax Act, June 7, 2001.<sup>80</sup> Since all settlement trusts are calendar year taxpayers,<sup>81</sup> the 2001 calendar year is the first year ending after the date of the 2001 Tax Act. The 2001 income tax return of a trust reporting on a calendar year will be due April 15, 2002, although with extensions this could be as late as October 15, 2002.

Once made, the section 646 election is irrevocable and will be applicable to all subsequent years.<sup>82</sup> If multiple settlement trusts are sponsored by a single Alaska Native corporation, each trust has the option of making the election.

Although section 646 permits an existing trust to make the election as late as the extended due date of the trust's return for 2001, the reality is that the trustees will need to do their due diligence and decide on the election during 2001. There are several reasons for this deadline. First, since the election obligates the trust to pay a tax on its income without regard to a distribution deduction, a decision on the election will have to allow time for the trust to satisfy any estimated tax obligations it will have.<sup>83</sup> A decision during 2001 should allow most electing settlement

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79. 2001 Tax Act § 671, 115 Stat. at 144 (adding § 646(b) to the I.R.C.). The author understands from informal conversations with the IRS National Office that the income tax return for the trust may contain a box by which the section 646 election can be made by a checkmark. As this article goes to press, samples of the form are not yet available for review.

80. The date the 2001 Tax Act was signed into law by President George W. Bush.

81. I.R.C. § 644(a) (1994).

82. 2001 Tax Act § 671, 115 Stat. at 144 (adding § 646(c)(3) to the I.R.C.). As will be discussed below, the entire 2001 Tax Act will sunset on December 31, 2010. Thus, from a technical tax perspective, as the law now reads, the section 646 election will bind a settlement trust only until such date. However, the language of section 646 specifies that the election is applicable to all subsequent years. Therefore, if the sunset date of December 31, 2010 is eliminated or extended, then existing elections would be binding after that date.

83. An electing trust has no special exemption from the estimated tax penalty provisions of I.R.C. § 6654. *See also* I.R.C. § 6654(l). Due dates for estimated tax payments relative to the 2001 taxable year are April 16, 2001, June 15, 2001, September 17, 2001 and January 15, 2002. Of course, nothing *prevents* an electing settlement trust from availing itself of one of the safe harbors from the estimated tax penalty contained within section 6654. *See, e.g.*, I.R.C. § 6654(d)(1)(B)(ii) (providing a limitation based upon

trusts sufficient time to comply with their respective estimated tax obligations for 2001. Second, if the election is to be made, the trust will want to allow adequate time to inform its beneficiaries of the tax status of the distributions during 2001 so that the beneficiaries can do their own tax planning. Third, the election decision needs to be made early enough to allow time for the trust to do its own tax planning so as to minimize its taxable income, because no distribution deduction will be allowable once the election is made.

The trustees should formally direct the trust's officers to make the election through a written resolution adopted with whatever formalities are described in the trust agreement.

### C. Taxation of Contributions to the Settlement Trust

After the effective date of a section 646 election, the contributions to that trust are no longer deemed distributions to the shareholders of the Native corporation. This means there will be no phantom income from contributions to the trust, regardless of whether the corporation has earnings and profits, and regardless of whether each shareholder has adequate basis in his or her stock.

Regrettably, the legislation did not address the I.R.C. section 311(b) issue. Under section 311(b), the sponsoring Native corporation must recognize gain when appreciated assets are contributed to the settlement trust.<sup>84</sup> It is not clear why the legislation did not address this issue. I.R.C. section 311(b) causes worry because gain recognition is a strong disincentive against contributions of ANCSA land to a settlement trust, even though the legislative history of ANCSA section 39 (the settlement trust provision) clearly shows that Congress envisioned settlement trusts (at least in part) as holding devices for ANCSA land.<sup>85</sup>

Although section 646 references transfers made after the election, the protection of section 646(c) should apply not only to physical contributions after the election is effective, but also to contributions deemed for tax purposes to be made after the election is effective. An example would be a defective grantor trust,<sup>86</sup> which results because the settlement trust has been structured to be revocable by the sponsoring Native corpo-

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100% of the prior year's tax).

84. I.R.C. § 311(b).

85. S. REP. NO. 100-201, at 35 (1987), *reprinted in* 1987 U.S.C.C.A.N. 3269, 3285; H.R. EXPLANATORY STATEMENT, 133 CONG. REC. H11933 (Dec. 21, 1987), *reprinted in* 1987 U.S.C.C.A.N. 3299, 3307.

86. *See* I.R.C. §§ 671-79. A defective grantor trust is a trust that has been deliberately structured so that the income and trust corpus still belong to the sponsoring Native corporation for tax purposes. Waiver of the provision causing grantor trust status converts the grantor trust into a taxable entity separate from the grantor. Assets in the formerly defective grantor trust have been transferred (for tax purposes) from the grantor.

ration. If the settlement trust makes the section 646 election, and the sponsoring Native corporation then waives its right to revoke the trust, a contribution to the settlement trust occurs for tax purposes when the waiver occurs.<sup>87</sup> Such a contribution should be protected by section 646(c), even though the transfer of assets to the trust was physically made prior to the effective date of the section 646 election.

#### D. Taxation of an Electing Settlement Trust

Following the section 646 election, the electing trust will be taxed under section 646(a) on all its income (other than net capital gain) annually at the lowest rate specified in I.R.C. section 1(c).<sup>88</sup> Since another provision of the 2001 Tax Act<sup>89</sup> made a 10% rate the lowest rate in section 1(c), effective January 1, 2001, it follows that an electing settlement trust is immediately subject to a 10% rate on its ordinary income (including short-term capital gain).

An electing settlement trust's taxable income is to be computed in the same way as for other trusts, except that no distribution deduction is allowable.<sup>90</sup> As discussed below, after the section 646 election, beneficiaries will pay no tax on the taxable income of the trust that is distributed. This effectively *reverses* the incidence of tax on trust income applicable to other trusts, as to which there is only one level of tax on distributed income, imposed at the beneficiary level at their normal marginal rates. While the distributed income of an electing settlement trust will also be subject to only one level of tax, that tax will be imposed at the trust level at a 10% rate.

For long-term capital gains,<sup>91</sup> an electing settlement trust is subject to the same rates as would apply to a taxpayer who is otherwise subject to tax only at the lowest rate (10%) in section 1(c).<sup>92</sup> Further, if the trust has any recognized gains from assets held for five years or more, these are taxable at 8%. Although the five-year period starts December 31, 2000 for most taxpayers,<sup>93</sup> a special rule applies to taxpayers subject to

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87. To avoid any possible confusion about the timing, the settlement trust in the foregoing example might make the section 646 election in 2001, and then the Native corporation might waive the power to revoke during the 2002 year of the settlement trust. This squarely places the deemed contribution after the section 646 election has been made.

88. 2001 Tax Act, Pub. L. No. 107-16, § 671, 115 Stat. 144, 144 (adding § 646(c) to the I.R.C.).

89. *Id.* § 101(a)(i)(1)(A)(i), 115 Stat. at 41.

90. *Id.* § 671, 115 Stat. at 146 (adding § 646(g) to the I.R.C.).

91. Presently, an asset has to be held for more than 12 months before its gain will be a long-term gain. I.R.C. § 1222(3).

92. *Id.* § 1(h)(1)(B).

93. *Id.* § 1(h)(2)(B)(ii).

tax at the lowest marginal rate whereby the actual holding period will be used in determining eligibility for the 8% rate.<sup>94</sup> This presumably applies to an electing settlement trust since it too is taxable only at the lowest marginal rate. As a practical matter, this may be of little consequence, since portfolio managers tend to turn their security investments over far more frequently than once every five years.

The tax imposed by section 646(a) is “in lieu of” the other income taxes under Chapter 1 of Subtitle A of the I.R.C.<sup>95</sup>

#### E. Taxation of Beneficiaries

Subsection 646(e) provides a four-tier system to determine whether beneficiaries will be taxed on the distributions during a given year from an electing settlement trust. The tiering system simply takes the aggregate trust distributions for a year and then characterizes them in the hands of the beneficiaries by reference to amounts determined by the trust’s and/or the sponsoring Native corporation’s own tax attributes. Three of these four tiers characterize distributions as being tax free, and only those distributions that are characterized by the third tier produce taxable income to the recipient beneficiaries. A more detailed discussion of each of these tiers follows.

The first tier (section 646(e)(1)) characterizes distributions in a given year as tax free up to an amount that is equal to the trust’s taxable income during the current year, reduced by income taxes paid, but increased by tax exempt income received.<sup>96</sup> As an example, assume that an electing trust has \$100X of taxable income, that it has \$0X of tax exempt income and that it pays \$10X in taxes. The tier one tax free amount is \$90X (\$100X - \$10X + \$0X).

The second tier is also a tax free tier, with the aggregate amount that is characterized by this tier being equal to the trust’s taxable income, as adjusted, during all election years, with a further reduction for all distributions that have been tax free under tier one in all election years.<sup>97</sup> In effect the second tier permits tax free distributions of accumulated taxable income, assuming the trust instrument permits its distribution. The rationale of the tax free nature of the first two tiers is that the electing settlement trust has already paid the tax on these amounts. As an example, assume that an electing trust has \$400X of taxable income in all election years, including \$0X of tax exempt income, that it pays a total

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94. *Id.* §§ 1(h)(2)(A), 1(h)(9).

95. 2001 Tax Act § 671, 115 Stat. 144, 144 (adding § 646(a) to the I.R.C.). As both the regular tax and alternative minimum taxes are taxes on income imposed by Chapter 1 of Subtitle A of the I.R.C., both are superseded by the section 646(a) tax.

96. For simplicity, we refer to this as “trust taxable income, as adjusted.”

97. 2001 Tax Act § 671, 115 Stat. at 145 (adding § 646(e)(2) to the I.R.C.).

of \$40X in taxes, and that it has previously distributed \$310X in all election years (including the tier one amounts for the current year). The tier two tax free amount is \$50X ( $\$400X - \$40X + \$0X - \$310X$ ).

The third tier is the only tier that causes beneficiary taxation and is the most complex.<sup>98</sup> The purpose of the third tier is to make distributions of principal taxable so as to limit the possibility that a sponsoring Native corporation with earnings and profits will bail out those earnings and profits using an electing settlement trust as a conduit. Taxability is accomplished by deeming the distributions characterized by this tier as being made by the sponsoring Native corporation.

The amount of trust distributions that are characterized by the third tier is the lesser of three amounts: (1) the trust distributions remaining after characterization under tiers one and two; (2) the accumulated earnings and profits of the sponsoring Native corporation; or (3) the current earnings and profits of the sponsoring Native corporation. Both the current and accumulated earnings and profits of the sponsoring Native corporation are to be determined after making adjustments for any distributions actually made by the Native corporation during that same tax year.

As an example, assume that after the distributions in the current year have been characterized by tiers one and two, distributions of \$20X remain uncharacterized. The sponsoring Native corporation has negative accumulated earnings and profits, but has \$25X of current earnings and profits. All \$20X of the remaining uncharacterized distributions are characterized as tier three distributions, and are therefore fully taxable to the beneficiaries as regular corporate distributions (even though actually paid out by the trust).

Any trust distributions that fall into tier three are to be treated for all tax purposes as being made by the sponsoring Native corporation. This invokes a duty in the corporation to send Forms 1099-DIV to shareholders reporting the distribution.<sup>99</sup> The electing settlement trust cannot know the amount of its distributions that fall into the third tier without knowing the current and accumulated earnings and profits of the sponsoring Native corporation. Furthermore, the sponsoring Native corporation cannot know the total tier three distributions it has been deemed to have distributed without knowing the total trust distributions in excess of the tier one and tier two amounts. Therefore, it is obvious there will have to be coordination between the electing trust and the sponsoring Native corporation. While the statutory scheme codifies a duty on the electing trust to provide this information to the sponsoring Native corporation, the reality is that the exchange of information needs to be between both parties. As a practical matter, this exchange of information

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98. § 671, 115 Stat. at 145 (adding § 646(e)(3) to the I.R.C.).

99. § 671, 115 Stat. at 147 (adding § 6039(H)(d)(2) to the I.R.C.).

should not present a great problem, as most settlement trusts have the same accountants as their respective sponsoring Native corporations, and are already managed to some degree in a coordinated manner for financial purposes with that Native corporation.

Since the tier three amounts are for all intents and purposes a corporate distribution, the amount of tier three distributions will have to be included as a part of the calculation of earnings and profits the corporation submits (presently Form 5452). Thus, the tier three amounts will be disclosed to the Service as tier three amounts in two places: once in a statement that is part of the electing settlement trust's tax return, and once on the corporation's Form 5452. It will also be disclosed on the Forms 1099-DIV sent to the corporation's shareholders and to the IRS. However, unless the taxpayer provides appropriate supplemental language on the face of the Forms 1099-DIV, these amounts would simply appear as regular corporate distributions and not as tier three amounts.

In rare situations, a settlement trust may choose to distribute appreciated property in kind.<sup>100</sup> The default tax treatment, per I.R.C. section 643(e)(2), is that no gain is recognized by the trust and the beneficiaries simply succeed to the trust's existing basis. However, section 643(e)(3) allows the trust to elect to treat the fair value of the property as the amount of the distribution and to recognize gain by the trust, so that the beneficiaries will take a fair market value basis. Section 646(e) expressly provides that an electing trust will have the flexibility of section 643(e).<sup>101</sup>

The remaining tier for distributions by an electing settlement trust is tier four (section 646(e)(4)). Tier four will be applicable only if the limitation on tier three is imposed by either the current or the accumulated earnings and profits of the sponsoring Native corporation (since there

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100. The author believes this situation will be rare, because of the logistical ease with which a *pro rata* cash distribution can be accomplished as opposed to an in-kind distribution to several hundred, or even thousand, settlement trust beneficiaries.

101. The Senate Report can be read to suggest that the § 643(e) election determines the amount of an in-kind distribution only in tier three situations, and that in determining the amount of the distributions that must initially be allocated under § 643(e)'s tiering system, the fair market value of property is to be used. SFC Technical Explanation, *supra* note 77, at 168 n.113; *see also* Conference Report, *supra* note 78, at 302. This is incorrect given the language of section 646(e), which simply characterizes the aggregate trust distributions during a given year for tax purposes by reference to the dollar totals of each tier. Section 643(e) contains no mechanism whereby a given distribution can be viewed as being made from or sourced in a particular tier. It follows that to maintain the internal consistency of section 646(e)'s tiering system, the same value has to be used to calculate *both* the aggregate distributions for the year *and* the amount that falls into tier three. Since section 646(e) is clear that the distribution value is to be determined under section 643(e) for tier three purposes, it follows that the section 643(e) value must also be used in determining the aggregate distributions during the year.

will be nothing to fall into tier four if the trust's distributions provide the limit on tier three amounts). Tier four amounts are to be treated as distributions in excess of the distributable net income of the trust, which is tax-speak for "non-taxable."<sup>102</sup> The rationale of the tax-free fourth tier is that anything that is distributed beyond the third tier is a distribution of something other than bailed out corporate earnings.

As an example, assume that after the distributions in the current year have been characterized by tiers one and two, distributions of \$20X remain uncharacterized. The sponsoring Native corporation has negative accumulated earnings and profits, but has \$15X of current earnings and profits. \$15X of the remaining uncharacterized distributions are characterized as tier three distributions, while the remaining \$5X of distributions are characterized as tier four and are therefore tax free to the beneficiaries.

The application of the four tiers can be summarized by the following general rules:

(1) If all an electing trust does is distribute its trust taxable income, as adjusted, for the current year, or the trust taxable income, as adjusted, in all election years minus prior distributions, the beneficiaries will not have taxable income;

(2) If an electing trust distributes an amount in a given year greater than that described (because it permits principal distributions or because it is liquidating), the corporate earnings and profits will usually be the relevant measuring point in determining taxation to beneficiaries;

(3) Since many Native corporations have large deficits in their accumulated earnings and profit accounts by virtue of past net operating losses, in many cases tier three taxation will be limited to the current earnings and profits generated during the year of the distribution;

(4) Even with current year corporate earnings and profits defining the amount of tier three income, corporate distributions during that year can be used to eliminate the current earnings and profits, with the result that trust distributions will belong in tier four, the final non-taxable tier.

#### F. The Prophylactic Rules

Section 646 contains three rules to limit abuse.

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102. I.R.C. §§ 652(a), 662(a) (1994).

1. *Transfers of Trust Units Must Be Limited.* The first anti-abuse rule is contained in section 646(f)(1), which provides adverse tax consequences if the beneficial interests in an electing settlement trust become transferable in a manner not permitted by section 7(h) of ANCSA<sup>103</sup> with regard to the settlement common stock<sup>104</sup> of a Native corporation. The result is that the benefits of section 646 will be targeted to settlement trusts whose beneficiaries are primarily Alaska Natives, and the possibility that high bracket, non-Native taxpayers might acquire interests in settlement trusts to gain advantage of the low tax rates on passive income will be limited.

ANCSA section 7(h) expressly forbids creditor action against settlement common stock (such as seizure, levy, pledges and attachment), and permits transferability of settlement common stock only in limited situations,<sup>105</sup> primarily death transfers and via *inter vivos* gifts within the family.<sup>106</sup> So long as settlement trust units are transferable only in these limited circumstances, section 646(f)(1) is not triggered.

In practice, the “no transfer” rule likely will not be a great problem for settlement trusts, as most settlement trust agreements already provide that the beneficial interests in the trust are “stapled” to the stock of the sponsoring Native corporation. Such beneficial interests are transferable only in the same manner and to the same persons that the ANCSA stock can be transferred. Typically, too, the relevant trust agreements contain

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103. Section 7(h) does permit persons who are not of Alaska Native ancestry to acquire settlement common stock in a Native corporation, but only through a death transfer. Compare ANCSA § 7(h)(1)(C) (codified as amended at 43 U.S.C. § 1606(h)(1)(C)) (requiring Native or Descendant of a Native status for described transfers) with ANCSA § 7(h)(2) (codified as amended at 43 U.S.C. § 1606(h)(2)) (no such status required for death transfers). Upon its acquisition by a non-Native, settlement common stock becomes non-voting so long as it is held by that non-Native. The stock reverts to voting status when subsequently acquired by a Native or descendant of a Native. Assuming the trust units are stapled to the settlement common stock, it follows that non-Natives may also own beneficial interests in an electing settlement trust. By and large, non-Native ownership of settlement common stock is *de minimis*.

104. By definition, settlement common stock is the non-transferable stock received to effect the ANCSA settlement. ANCSA § 3(p) (codified as amended at 43 U.S.C. § 1602(p)).

105. A further exception allows the transfer of stock if necessary to maintain one’s qualification in a professional organization, but the provision is of no utility for the vast bulk of ANCSA shareholders. ANCSA § 7(h)(1)(C)(ii) (codified as amended at 43 U.S.C. § 1606(h)(1)(C)(ii)).

106. The permitted class of donees includes only a son, a daughter, a grandchild, a great grandchild, a niece, a nephew, and, if both the donor and donee are above the age of 18, a brother and sister. Gifts are not permitted “up” the family tree, i.e., to parents, grandparents, aunts or uncles. ANCSA § 7(h)(1)(C)(iii) (codified as amended at 43 U.S.C. § 1606(h)(1)(C)(iii)).

a spendthrift clause prohibiting alienation, and since December 2000, federal law has been clear that beneficial interests in a settlement trust are subject to creditor action only to the same extent as settlement common stock.<sup>107</sup> Taken together, all these mean that the trust units cannot be transferable in a forbidden manner, at least so long as transfers of the ANCSA stock are themselves restricted by section 7(h).

However, ANCSA contains a provision whereby the shareholders of the Native corporation may vote to make the ANCSA stock transferable.<sup>108</sup> To date no ANCSA shareholders have voted to make the settlement common stock of their corporation freely alienable, but this possibility exists. If the shareholders do vote to make the stock freely alienable and the trust's beneficial interests are still stapled to the (former) settlement common stock, section 646(f)(1) will be triggered, with the adverse consequences discussed below.<sup>109</sup>

To avoid this, any provision that staples trust units to the related settlement common stock needs to be accompanied by a decoupling provision that "unstaples" the trust units if the settlement common stock becomes freely alienable (for example, if ANCSA section 7(h) no longer applies to that stock). The unstapling provision also should provide that the transfer restrictions of ANCSA section 7(h) continue to limit transfers of the trust's beneficial interests.

If section 646(f)(1) is triggered, there are three major consequences. First, the existing section 646 election is revoked retroactively to January 1 of the year in which the trust units first become transferable in an impermissible manner.<sup>110</sup> Effectively, this returns the settlement trust to the subchapter J tax regime, with its steeply graduated rates. Second, the trust is forever barred from making another section 646 election.<sup>111</sup> Third, the distributable net income of the trust for the year in which the revocation of section 646 status occurs is increased by the lesser of the following amounts: (1) the current and accumulated earnings and profits of the sponsoring Native corporation (as of the current year's end, after giving effect to the corporation's own distributions), or (2) the fair market value of the assets within the trust.<sup>112</sup> Increasing the distributable net income of the trust has two consequences: (1) increasing the amount of deduction the trust can claim for distributions during that year (assuming

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107. ANCSA § 39(c)(8) (codified as amended at 43 U.S.C. § 1629e(c)(8)), *as added* by Indian Tribal Justice Technical and Legal Assistance Act of 2000, Pub. L. No. 106-559, § 302, 114 Stat. 2782.

108. ANCSA § 37 (codified as amended at 43 U.S.C. § 1629(c)).

109. 2001 Tax Act, Pub. L. No. 107-16, § 671, 115 Stat. 144, 145 (adding § 646(f)(1) to the I.R.C.).

110. *Id.*

111. *Id.*

112. *Id.*

the trust makes distributions in an adequate amount), and (2) increasing the amount of these distributions that beneficiaries must include in income. However, if the trust does not make such distributions, the increase in potential deduction and the increase in potential beneficiary inclusion are immaterial.<sup>113</sup>

Also, section 646(f)(3) exempts certain types of redemptions and liquidations of the trust from constituting a forbidden transfer.<sup>114</sup> The rationale behind exempting a liquidation of an electing trust from the punitive provisions of section 646(f)(1) is straightforward: in such a case there has been no transfer of unintended tax benefit to non-Natives, and the trust has simply been eliminated. The same rationale applies to a redemption of a trust unit. Since a redemption accomplishes no direct transfer of ownership to persons not of Alaska Native ancestry, there is no harm to be avoided.<sup>115</sup>

Section 646(f)(1) implicitly suggests that no settlement trust in which the beneficial interests are freely transferable from its outset may even make the section 646 election.<sup>116</sup>

2. *Transfers of Corporate Stock Must Remain Limited.* Section 646(f)(2) is the second anti-abuse rule.<sup>117</sup> This section provides that if the stock of the sponsoring Native corporation becomes transferable in a manner other than provided for in ANCSA section 7(h), and if the sponsoring Native corporation then makes a contribution to an electing settlement trust, the same consequences will befall the electing settlement trust as would occur if the trust's own beneficial interests became freely transferable.<sup>118</sup>

At the outset, it is difficult to see the harm at which this provision is directed, since it is the electing settlement trust, and not the sponsoring Native corporation, that receives the benefit under a section 646 election. As long as the trust units, themselves, are not freely transferable, Alaska Natives will continue to receive the benefits of the section 646 election.

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113. Contrary to what the Senate Report suggests (SFC Technical Explanation, *supra* note 77, at 167; Conference Report, *supra* note 78, at 302-03), increasing the distributable net income in and of itself does not increase the amount of tax that a trust would have to pay. Section 643(a) of the I.R.C. defines a trust's "distributable net income" to be its taxable income with certain adjustments. Under I.R.C. §§ 1(e), 641(a) and 641(b), the trust pays its income tax based on its *taxable income*, not its *distributable net income*.

114. 2001 Tax Act § 671, 115 Stat. at 146 (adding § 646(f)(3) to the I.R.C.).

115. Assuming a redemption is at the fair value of the beneficial interest being redeemed, the redemption neither increases nor decreases the interests of the other trust unit holders (and shareholders, in a corporate setting).

116. 2001 Tax Act § 671, 115 Stat. at 146 (adding § 646(f)(1) to the I.R.C.).

117. § 671, 115 Stat. at 146 (adding § 646(f)(2) to the I.R.C.).

118. *Id.*

Indeed, if a Native corporation with freely transferable stock owned by non-Natives wants to make a contribution to an electing settlement trust benefiting Alaska Natives, why is that not a good thing?

Nonetheless, the reach of section 646(f)(2) can be avoided, even if the stock of the sponsoring Native corporation becomes transferable, so long as (1) the trust units unstaple from the stock and (2) the trustees thereafter refuse to accept contributions from the Native corporation.<sup>119</sup>

Section 646(f)(3) excepts stock redemptions and corporate liquidations from the reach of section 646(f)(2), just as it excepts redemptions of trust units and trust liquidations.<sup>120</sup>

Another class of stock transfers should not trigger section 646(f)(2). Section 30 of ANCSA permits Native corporations within the same region to merge or consolidate notwithstanding any other provision of ANCSA.<sup>121</sup> In a typical merger, stock ownership in one corporation is exchanged for stock in another. This exchange constitutes a transfer of the stock in question, and absent section 30 of ANCSA, a merger of Native corporations would arguably violate section 7(h)'s prohibition on a transfer of settlement common stock. Because section 7(h) does not prevent a merger of Native corporations under ANCSA section 30, it follows that a section 30 merger should not trigger section 646(f)(2).

3. *Disallowance of Loss on Sales of Stock of Sponsoring Native Corporations.* Section 646(i) imposes a third anti-abuse rule.<sup>122</sup> Under section 646(i), any loss that a shareholder would otherwise recognize on a disposition of his or her stock in a sponsoring Native corporation is reduced by an amount attributable to assets transferred by the corporation to an electing settlement trust.<sup>123</sup>

This provision is directed at a perceived abuse situation where a Native corporation transfers a significant portion of its economic worth to an electing settlement trust, and then makes its settlement common stock transferable. If a shareholder then sells his or her stock for fair market consideration, a recognizable loss will likely be generated for tax purposes even though the shareholder has not really suffered an economic loss given the interest he or she retains in the electing trust.<sup>124</sup>

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119. *Id.*

120. § 671, 115 Stat. at 146 (adding § 646(f)(3) to the I.R.C.).

121. ANCSA § 30(a) (codified as amended at 43 U.S.C. § 1627(a) (1994)).

122. 2001 Tax Act § 671, 115 Stat. at 146-47 (adding § 646(i) to the I.R.C.).

123. *Id.*

124. Calling this an abuse situation presupposes there will be accommodation purchasers of the stock so as to generate the loss even though there will be little, if any, value to the corporation (because of the initial asset-stripping transfer). It also presupposes that a shareholder can effectively use the long-term capital loss being generated by offsetting it against capital gains, since the shareholder is otherwise limited each year to de-

It seems unlikely that these events will coalesce to produce an abuse situation. For I.R.C. section 646(i) to apply, the settlement common stock of the sponsoring Native corporation will have to be freely alienable, and this cannot occur until such time (if at all) that an absolute majority of the Native corporation's shareholders have voted to remove the ANCSA section 7(h) restrictions.<sup>125</sup> As noted above, ANCSA has permitted such a vote for some thirteen years, and to date, no Native corporation's stock has been made freely transferable. Although sentiments within the Native community may change, it seems unlikely as of this writing.

In any event, the loss disallowance rule works as follows. The shareholder would first compute the basis in his or her ANCSA stock.<sup>126</sup> This is no small task. Then the shareholder would determine whether a gain or loss has been realized by comparing the amount received on the disposition with the computed basis. If a gain is computed (disposition proceeds exceed basis), the section 646(i) rule has no application. If a loss is computed, section 646(i) may apply.

The shareholder then must determine whether there have been transfers to an electing settlement trust made on or after the first day the trust is treated as an electing settlement trust. If there are multiple electing settlement trusts, the question of post-election effective date transfers has to be answered trust by trust. If there are no such transfers, section 646(i) will not apply.

If there are contributions made after the effective date of a section 646 election, the next step is to determine the shareholder's "per share loss adjustment factor" for each such transfer.<sup>127</sup> This per share factor will be determined in two further steps, the first of which is to multiply the dollar amount of the transfer by a fraction, the numerator of which is the number of shares of settlement common stock held by the shareholder at the time of the transfer and the denominator of which is the total shares of settlement common stock outstanding at the time of the transfer.<sup>128</sup> This produces a loss adjustment factor allocable to the shareholder. The second step is to convert this factor to a per share factor by dividing by the number of shares owned.<sup>129</sup>

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ducting only \$3,000 of long-term capital loss. I.R.C. § 1211(b)(1) (1994).

125. ANCSA § 7(h) (codified as amended at 43 U.S.C. § 1606(h)).

126. The IRS has repeatedly ruled that an original ANCSA shareholder's basis includes his or her pro rata share of assets transferred from the government to the Native corporation as a part of the ANCSA settlement. *E.g.*, Priv. Ltr. Rul. 98-24-014 (Mar. 10, 1998); Priv. Ltr. Rul. 96-44-039 (July 30, 1996); Priv. Ltr. Rul. 93-29-026 (Apr. 28, 1993).

127. 2001 Tax Act § 671, 115 Stat. at 146-47 (adding § 646(i) to the I.R.C.).

128. *Id.*

129. *Id.*

This same calculation must be made for each transfer to an electing settlement trust made during the stockholder's ownership. One can only wonder whether the mathematical gyrations are worth the effort.

#### G. Tax Reporting

An electing trust does not have to send any Forms K-1 or 1099 to its beneficiaries.<sup>130</sup> If any of the trust's distributions are taxable to beneficiaries (e.g., a tier three distribution), the sponsoring Native corporation must send a Form 1099-DIV reporting those amounts to the beneficiaries by January 31 of the succeeding year. The electing trust and the sponsoring Native corporation must coordinate so that each can file correct returns with the IRS (and in the case of the corporation, report any tier three distribution on its own Forms 1099-DIV). However, the required coordination is far less burdensome to the electing trust than would be the sending of Forms K-1 to both its beneficiaries and the IRS.

What an electing trust does have to do is prepare and file its own tax return. It is presently unclear whether an electing trust will use the same Form 1041 that other trusts use. The author understands from conversations with the Forms Branch of the IRS National Office that consideration is being given to a special version of the Form 1041 applicable only to electing Alaska Native settlement trusts. As this article goes to press, it is unclear whether in fact such a form will be used. If such a form is to be used, it will need to be available for the 2001 filing season because 2001 is the first year for which the section 646 election can be made.

#### H. Effect of Sunset of 2001 Legislation

Pursuant to section 901(a)(1) of the 2001 Tax Act,<sup>131</sup> all provisions of the 2001 Tax Act (including section 671) will sunset on December 31, 2010.<sup>132</sup>

A settlement trust should not be deterred from making the section 646 election simply because the section 646 election and the reform in information reporting accomplished by section 6039H are not permanent features of the tax law. Given the six-year effort that led to the enactment of section 671 as a part of the 2001 Tax Act, it should be anticipated that there will be a concerted effort to make the section 646 election and section 6039H reporting a permanent part of the tax law.

However, even if one assumes that permanence is not achieved, the proper way to evaluate section 671 of the 2001 Tax Act is that Congress has provided a window during the tax years 2001 through 2010 in which

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130. § 671, 115 Stat. at 147 (adding § 6039H(b) to the I.R.C.).

131. § 901(a)(1), 115 Stat. at 150.

132. *Id.*

(1) unlimited contributions can be made to a settlement trust without adverse consequences to the shareholders of the sponsoring Native corporation; (2) a highly favorable rate (10%) is applicable to taxable income that is reinvested by the settlement trust; (3) the trust's beneficiaries do not have to pay tax on the distributions of taxable income made to them in exchange for a tax burden (at a favorable 10% rate) to be paid by the trust; and (4) streamlined information reporting may occur. Nothing in the 2001 Tax Act requires (or even suggests) any sort of recapture of benefits or further imposition of tax once the ten year period ends. By contrast, the statute and the legislative history indicate that the pre-section 671 law applies as if section 671 had never been enacted.<sup>133</sup> Congress would have to enact further legislation to accomplish recapture or a further tax, and there is an element of unfairness in imposing such an added burden after the decision has been made to make the election. In short, even if the relief of section 671 of the 2001 Tax Act is limited to 10 years, it is still significant tax relief.

#### VI. AN OVERVIEW OF THE ADVANTAGES AND DISADVANTAGES TO THE ELECTION

As discussed above, the mandate of Alaska law is that the trustees of a given trust will need to assess whether the section 646 election is in the best interests of the beneficiaries and the trust taken as a whole. While this standard is presumably subject to variation within the trust agreement, it is difficult to imagine that the trust agreement for an ANCSA settlement trust will stray far from this standard. With this in mind, the following is a "broad brush" summary of the relative pros and cons of a section 646 election.

##### A. Possible Advantages to the Election

The author sees seven possible advantages to the election. First, the election permits significant distributions to be made by the trust that are tax free to the beneficiaries. The importance of this cannot be overstated in an environment where many Native corporations make distributions that are of low tax impact to their shareholders.<sup>134</sup> The result will likely be that settlement trusts are finally on par with their sponsoring Native corporations in this regard. Furthermore, if the comparison is with the

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133. Conference Report, *supra* note 78, at 304.

134. Corporate distributions that are not currently taxable can result from several factors, chief among them being depletion deductions from exploitation of natural resources utilizing a fair market value basis under section 21(c) of ANCSA. It is beyond the scope of this article to explain this in detail, but it suffices to say that the basis rules of section 21(c) of ANCSA typically result in a situation where harvest activities can produce positive cash flows coupled with losses for federal income tax purposes.

existing tax regime for settlement trusts, nontaxable distributions mean that some beneficiaries will no longer need to file individual income tax returns, lose eligibility for the earned income credit, or have a portion of their social security benefits become taxable.<sup>135</sup>

Second, in a related sense, the ability to elect under section 646 will lessen the need for a Native corporation to conduct its natural resource activities in an unfavorable market environment solely to generate depletion deductions to make its distributions not currently taxable. With the possibility of a section 646 election, the Native corporation now has the option of shifting its passive investment assets to a settlement trust and making significant tax free distributions regardless of whether the corporation conducts the natural resource activity.

Third, the elimination of Form K-1 relieves much administrative burden. Whether the comparison is with a corporation using passive investments to generate the funds for distribution, or with a settlement trust that has not made the election, the result is the same - - less paperwork is required.

Fourth, making the election allows future contributions to be made to an electing trust without producing phantom income to the beneficiaries. Even if no contributions to an existing settlement trust are presently contemplated, this greatly increases flexibility in tax and financial planning between the sponsoring Native corporation and the electing settlement trust. And for those considering a new settlement trust, the section 646 election removes the need for tax-driven gymnastics to eliminate corporate earnings and profits in the years the settlement trust would be funded.

Fifth, the 10% tax rate for electing trusts is probably about half of what the beneficiaries would pay in the aggregate on the trust distributions. For those existing settlement trusts that have a preplanned distribution amount<sup>136</sup> that continues after the election, the effect will be an increase in the net distribution that is kept by the beneficiaries after the income tax burden. While in this circumstance trust outlays will also increase (by the amount of the 10% tax burden), the beneficiaries will in the aggregate have an even larger pickup in net benefit retained, since the assumed beneficiary rate is considerably higher than the imposed rate on the trust. In effect, the federal government is subsidizing this increase in benefits.

Sixth, the 10% tax rate for electing trusts is about one-quarter of the rate a settlement trust would pay on its reinvested ordinary income and short term capital gains, and about half of what a settlement trust would

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135. Taxable trust distributions are included in determining whether the relevant income thresholds have been met; nontaxable distributions generally are not.

136. Examples of these trusts include an elders trust, an educational trust, and a funeral benefits trust.

otherwise pay on its reinvested long term capital gains. For those settlement trusts that are forced by the nature of their investments to generate taxable income that is not distributed each year, the savings will be dramatic.

Seventh, for settlement trusts that provide funeral benefits, the section 646 election would solve a lingering problem: the lack of a proper tax identification number under which taxable trust distributions made for the benefit of the decedents can be reported to the IRS. The proper course is to use the estate's tax identification number, even though in most cases no tax identification number will ever be obtained for the decedent's estate. Reporting under the decedent's number is incorrect, yet that is the only tax number available to most Native corporations and the settlement trusts they sponsor.<sup>137</sup>

#### B. Possible Disadvantages to the Election

The author sees at least seven possible disadvantages to the election. First, in the case of an existing settlement trust that is permitted by its trust agreement to make principal distributions,<sup>138</sup> or in the case of an existing trust that is liquidated, some portion of such amounts may be taxable to the beneficiaries as tier three income if the section 646 election has been made and the sponsoring corporation has earnings and profits in the year of distribution. This is a negative change from existing law, because such a distribution of principal is currently entirely tax free to recipients. The magnitude of this factor remains to be seen, but many sponsoring Native corporations have large accumulated earnings and profit deficits that will limit the amount of taxation under tier three to only the amount of any current year earnings and profits.

On the other hand, additional taxation of the beneficiaries could result from a section 646 election over current law if each of the following occur in the same tax year: (1) a sponsoring Native corporation is exceptionally profitable in a given year, (2) that corporation does not have enough depletion or other deductions to eliminate the profit, (3) that corporation does not distribute any of those profits to its shareholders, and

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137. The same problem arises in the context of other taxable trust distributions made to a decedent's estate. In practice, most settlement trusts limit this issue by reissuing the stock in the new owner's name as quickly as possible so the successor is the owner of the distributions declared after death. With funeral benefits, this approach is not available because of the need to pay the funeral benefits immediately to obtain burial and related services.

138. Technically, it is the amount of the distribution that exceeds the amount of the trust's distributable net income for the current year that is tax free to the beneficiaries under I.R.C. sections 652 and 662. The calculation of distributable net income proceeds directly from the trust's taxable income. I.R.C. § 643(a) (1994). Distributable net income is thus related to, but is not the same as, the trust's taxable income.

(4) one of the settlement trusts it sponsors makes a principal distribution or liquidates.

Second, if the sponsoring Native corporation's stock some day becomes transferable through sale, and if a shareholder thereafter sells his or her stock in that Native corporation at a loss, section 646(i) may disallow some portion of that loss as a result of the section 646 election. However, although prediction of the future is not really possible, few Native corporations to date have shown any inclination to make their shares freely transferable. Thus, the possibility of a section 646(i) loss disallowance seems remote.

Third, if the trust units of an electing trust become transferable in a manner not permitted under ANCSA section 7(h), the opportunity to continue the election is lost and the distributable net income of the trust benefits is increased. This increase could be as much as the entire fair market value of the trust.

Fourth, a trust forever may lose the benefits of section 671 and its distributable net income may increase as described above if both of the following events occur: (1) the sponsoring Native corporation's stock someday becomes transferable in a manner not presently permitted by section 7(h) of ANCSA and (2) the sponsoring Native corporation thereafter makes a contribution to the electing trust.

Fifth, if the electing trust desires to maximize tax benefits, internal accounting for an electing trust will become more complex even though the information reporting is less burdensome. This is because the trust's income and gains will have to be managed so as to produce enough taxable income so that the distributions are tax free and, at the same time, not produce any more "excess" (i.e., undistributed) taxable income than is absolutely necessary. To some degree this issue is addressed by present law, but present law imposes no minimum target taxable income that must be achieved to prevent trust distributions from becoming taxable.<sup>139</sup>

Sixth, for electing trusts making educational distributions, it is unclear whether tax free distributions (as would result from the section 646 election) will be eligible for the Hope or Lifetime Learning Credits.<sup>140</sup> In the applicable regulations governing these credits, the I.R.S. has suggested that tax free amounts (such as a Pell grant) will not qualify for the credit, but there is no direct authority as to whether the same result would be obtained for tax free distributions from an electing settlement

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139. An electing trust may have to keep track of four sets of numbers: one for "regular" tax purposes, a second for financial reporting purposes, a third for any limitations on distributions imposed by its governing instrument, and a fourth to calculate how much may be distributed while avoiding tier three income to the beneficiaries.

140. I.R.C. §§ 25A(b)-(c).

trust.<sup>141</sup> Of course, the recipient of the educational grant would still be eligible to claim a credit for other amounts spent on his or her education. Since the limits for the amount of these credits which can be claimed are relatively low, elimination of the tax free settlement trust distributions from the credit base may not have a large overall impact given the costs of education.

Seventh, by making the section 646 election, the trust is taking on an added tax liability (i.e., 10% of the trust's total taxable income compared with the marginal rate structure under Subchapter J as to its undistributed income). Formerly, most of this new tax liability would have been paid at the beneficiary level. While this shift in tax burden operates as an increase in net after-tax benefit to most beneficiaries over the near term, it has to be paid for by either making smaller distributions (never popular with beneficiaries) or by reducing the growth of the trust. Over the long term, reducing the growth of the trust means that the electing trust will never grow as large as it would have without the election. Having a smaller trust fund to invest will mean that the distributions to beneficiaries will also be smaller, eventually even on an after-tax basis. In addition, there is an intergenerational aspect. The beneficiaries that will benefit from the election by the increased net after-tax benefit in the earlier years will be the existing beneficiaries, while those that will eventually suffer the reduced benefit from lowered trust earnings (due to a smaller corpus) are the beneficiaries during future decades.

#### VII. IMPROVING SECTION 671 OF THE 2001 TAX ACT

Section 671 of the 2001 Tax Act is a clear improvement over existing law. However, as with most legislation, it needs some fine tuning. The most important of these areas for improvement are the following:

First, eliminate the recognition of gain under I.R.C. section 311(b) when ANCSA land<sup>142</sup> is contributed to an electing trust. Congress intended Native corporations to have the option to place ANCSA land in a settlement trust for greater protection from creditors and the like, but the possibility of the Service finding an appreciated value at the time of transfer is enough to deter such contributions. The bail out potential is nonexistent relative to ANCSA land, since ANCSA already expressly forbids a settlement trust from disposing of ANCSA land it receives, except for reversions back to the Native corporation.<sup>143</sup> In short, no opportunity exists for a Native corporation to transfer appreciated ANCSA

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141. *See, e.g.*, I.R.S. Notice 97-60, 1997-2 C.B. 310.

142. For this purpose, the "ANCSA land" would be any land that is deemed under federal law to have been conveyed pursuant to ANCSA.

143. ANCSA § 39(b)(1)(B) (codified as amended at 43 U.S.C. § 1629e(b)(1)(B)).

land to an electing trust in order to gain the benefit of a low tax rate in anticipation of sale.

Second, the sunset of section 671 on December 31, 2010 should be repealed. If the goal is to encourage the use of settlement trusts to provide benefits over the long term to Alaska Natives, the tax regime applicable to such trusts also needs to be long term.

Third, the Staff of the Joint Committee should eventually issue a Technical Explanation<sup>144</sup> to explain the 2001 Legislation and to clarify the language of the Senate Report. This will make it clear that I.R.C. section 643(e) sets the value for all purposes of I.R.C. section 646(e)'s tiering system when in-kind property is distributed by an electing trust.

#### VIII. SUMMARY

Section 671 of the 2001 Tax Act is an important step forward in realizing the potential of settlement trusts for the Alaska Native community. At last, some thirteen years after settlement trusts were first authorized in the 1988 Amendments to ANCSA, the major tax hurdles of phantom income on contribution, regressive rates on reinvested income, unfavorable beneficiary taxation and excessive information reporting have been removed. The opportunity now exists for settlement trusts to reach their potential as long-term planning tools.

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144. Usually called the "Blue Book" or the "Blue Booklet" because of the color of its cover.