IRS Finally Agrees Trust Per Capita Distributions are Tax Exempt

…with some limits.

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On March 10, 2014, the IRS issued the long-awaited guidance on the tax treatment of per capita distribution of tribal trust revenue. Notice 2014-17. (http://www.irs.gov/pub/irs-drop/n-14-17.pdf). The IRS reversed its earlier stance and now agrees that these distributions are not includible in the gross income of the recipients. However, the IRS carved out three exceptions to this tax exemption: (1) compensation that has been mischaracterized as a trust per capita distribution; (2) business profits that have been mischaracterized as trust revenue; and (3) gaming revenue that has been mischaracterized as trust revenue.

Importantly, Notice 2014-17 allows an opportunity for comment from tribes until September 17, 2014. In the meanwhile, the guidance can be relied upon by tribes and the IRS to evaluate the tax effect of tribal disbursements that have been identified as trust per capita distributions. The IRS stated recently that in an effort to ensure consistency in the application of the interim guidance, any issues that may arise at the IRS field level involving per capita distributions will be centrally reviewed at the national level of the IRS Indian Tribal Governments Office.

Some brief history about what precipitated Notice 2014-17 is in order. A few years ago, the IRS approached at least two northwest tribes and initiated an audit of the tribes' distributions to members. Among the various types of distributions that a tribe makes, the IRS reviewed the distributions identified as trust "per capita" payments to members. The IRS asserted that revenue earned by the tribe from its trust resources (such as timber, coal, oil, etc.) was taxable when distributed per capita to its tribal members. In other words, each tribal member was required to pay tax on the share of tribal trust revenue they received and that the tribe was required to issue Forms 1099 to each of those recipients.

The tribes, of course, disagreed with the IRS. For the past two years or more, in concert with the National Congress of American Indians and other national and regional tribal organizations, the tribes argued before Congress, Department of Treasury and Department of Interior that the Per Capita Act of 1983 explicitly confirmed the long-established law that the per capita distribution of tribal trust resource revenue is exempt from federal and state tax.

Before issuing Notice 2014-17, the IRS consulted with the Department of Interior and the U.S. Trustee. In addition, on January 27, 2014, the IRS hosted an open phone "consultation" with tribes to announce the ruling they expected to issue and to take questions and comments. The IRS did not release the actual ruling at that time, but instead disclosed the general parameters of the expected ruling. Consequently, tribes and tribal organizations requested that the ruling be issued in interim format to allow meaningful review and comment; this request was granted.

Notice 2014-17 represents the IRS concession that the Per Capita Act protects distributions of tribal trust revenue from taxation. The limitations to the IRS concession of this issue are important, however. By Notice 2014-17, the IRS reserves its authority to re-characterize a trust per capita distribution as a taxable payment if they believe the tribe has abused the arrangement. The IRS will look to the facts and circumstances of the arrangement to determine if a "Trust Account is used to mischaracterize taxable income." In other words, the IRS will not simply accept that a distribution characterized by the tribe (or the Department of Interior/U.S. Trustee) constitutes a tax-exempt "trust per capita" payment, when in substance it is really something else. (*i.e.*, the classic form vs. substance test).

Here are the three types of abusive situations that the IRS has carved out as exceptions to tax exemption, based in part or in whole on allegedly real transactions the IRS has encountered in its audits of tribes over the years.

Exception 1, Disguised Compensation. This exception addresses whether a distribution of trust income really qualifies as a "per capita" distribution. If the payment is compensation, it cannot qualify as a tax exempt per capita distribution. To illustrate this point, the IRS sets out in Example 1 a scenario where the tribal council authorizes per capita distributions to three subsets of members. All members receive $1x in trust distributions, elders receive $2x, and two individuals who provide services to the Housing Authority as Director and Assistant Director comprised the third subset and received $15x in trust distributions. Notably, in prior years the Director and Assistant Director of the Housing Authority had been receiving taxable wage bonuses and their new "per capita" distribution is in lieu of a bonus. The distribution of trust revenue to the Housing Authority officials will be considered compensation by the IRS. This example illustrates that disparate distributions to subsets of members ($1x to members and $2x to elders) may qualify for tax exempt treatment as "per capita" distributions. However, trust distributions of a significantly larger sum to members who provide services to the tribe may be reclassified as compensation by the IRS. The example does not make clear whether it is the 15 to 1 ratio difference in the size of the trust distribution, the prior practice of paying those particular members taxable compensation of the same amount, remitting funds to those individuals in their capacity as Directors who serve an agency, or all the factors combined that make the arrangement abusive.

Exception 2, Disguised Business Profits. This exception addresses the misuse of a trust account to run taxable corporate business profits through the tribe's trust account in an effort to make those profits tax exempt. In this situation, the tribe intentionally mischaracterizes corporate business profits as "rents" from trust land and then redistributes the same amount of those "rents" as trust "per capita" payments to the group of members who own the corporation. Specifically, the tribe arranged for one of its corporate enterprises (located on trust land) to deposit an amount approximating the corporate net revenues into trust and to label it as "rent." Subsequently, members of the tribal council authorized the per capita distribution from trust of essentially the same amount to the owners of the Corporation. There are a number of red flags in this scenario. One, the so-called "rent" was tied to the amount of corporate profits and not based on a determination of fair market value rent. Second, the distribution of trust was not necessarily "per capita" or *pro rata*, but rather it was roughly equivalent in amount to what was deposited as "rent" and, moreover, distributed only to tribal members who owned the corporation.

<u>Exception 3, Disguised Gaming Revenues</u>. This exception addresses whether funds deposited into trust really qualify as trust revenue. By this exception, the IRS has stated that a tribe may not evade the legal reach of the Indian Gaming Regulatory Act (IGRA) by intentionally converting its gaming revenue into trust revenue. In this example, a tribal casino (located on trust land) agreed to pay rent in an amount equal to 50% of its net gaming revenue, with the other 50% of revenue being distributed to the tribe. The rent was deposited into trust and then distributed per capita from trust to every tribal member. The IRS ruled that those trust distributions are mischaracterized gaming revenues which are taxable under IGRA. This example does not provide a bright-line test for what may be considered by the IRS to constitute an abusive tax scheme. It seems the IRS is saying that a lease rate based on 50% of net revenues is abusive. But, clearly a casino can have legitimate rental expenses. So, is a rental rate amounting to 30% of net revenue bona fide? What if a lease rate at 50% of net revenue was predicated upon market analysis and fair market value determination of rent? The answer to these questions is uncertain, but what is relatively certain is that a process of audit or review of tribal records will ensue to determine whether the IRS concludes the arrangement is abusive.

Notice 2014-17 represents a significant policy shift by the IRS to publically agree that the per capita distribution of trust revenues is tax exempt. I believe the intent of Notice 2014-17 was to clarify the tax treatment of trust per capita distributions so that tribes could confidently rely on their dealings with Department of Interior and the U.S. Trustee as it relates to the administration of trust revenues. However, I am concerned the guidance will do little to reduce the number of IRS audits of per capita distributions because of the stated exceptions in Notice 2014-17. The exceptions are very broad and cannot possibly (nor are they meant to) encompass every circumstance that could be seen as an abusive manipulation of the Per Capita Act protections. So, that necessarily means the IRS will have to look at tribal trust per capita arrangements on a case by case basis to make a determination. Put another way, the IRS will still ask to review the trust per capita distributions by tribes as part of an audit or review. And, if there are disparate amounts distributed to subsets of members, I predict the IRS will investigate further to determine whether the tribe mischaracterized the transaction as a tax-free trust per capita. Rental arrangements with enterprises operating on trust land may also be scrutinized as part of a trust per capita audit or review. In some respects, the ruling gives the IRS a reason to audit instead of putting the issue to rest.

I am also concerned about what appears to be a Department of Treasury incursion into the jurisdiction of the Department of Interior. The exceptions to tax exemption set forth in Notice 2014-17 essentially dispute whether Title 25 regulations have been followed. For instance, Exception 1 disputes whether the distributions qualify as "per capita" payments. Exceptions 2 and 3 dispute whether certain funds qualify to be deposited into trust or are of a "trust" character. In both cases, Title 25 defines what can be deposited into trust (25 C.F.R. §§ 115.700-701) and what qualifies as a "per capita" distribution. (*e.g.,* 25 C.F.R. 290.2). Department of Interior has jurisdiction and authority over Title 25 of the U.S. Code. Department of Treasury and the IRS have jurisdiction and authority over Title 26 of the U.S. Code, the Internal Revenue Code. So, what is to happen if, for instance, the U.S. Trustee accepts rent deposits into trust but the IRS later questions whether the rent exceeds fair market value? Notice 2014-17 seems to give the IRS the authority to re-characterize rents from trust land as something other than bona fide trust revenue. Fundamentally, this means the IRS may question the U.S. Trustee's administration of trust funds under Title 25.

Certainly, the IRS has to administer the Internal Revenue Code and, to that end, the exceptions outlined in Notice 2014-17 are meant to police against abusive schemes to evade federal tax. Yet, in their public comments during the "consultation" phone call with tribes on January 27, 2014, the IRS and Treasury acknowledged that the exceptions outlined in Notice 2014-17 describe rare situations. If that is the case, then why not plainly concede that trust revenues may be distributed per capita on a tax exempt basis and rely on collaboration with the U.S. Trustee and upon existing law to deal with the rare instances where a tribe may abuse that protection? Payment for services has always been compensation and Notice 2014-17 does not alter that rule. The Indian Gaming Regulatory Act governs the distribution of net gaming revenues and Notice 2014-17 does not materially advance the plethora of rulings which confirm that those revenues are taxable when distributed.   And, the IRS always has in its arsenal of arguments the classic test of substance over form to attack tax avoidance schemes.

Presumably in their consultations with IRS leading up to Notice 2014-17, the U.S. Trustee and Department of Interior strongly conveyed that they have a robust system for ensuring that what goes into trust complies with Title 25 and that authorized distributions of those trust revenues comply with Title 25. Given that the abusive scenarios described in Notice 2014-17 are rare, then it would seem that, on the whole, Title 25 is being administered properly. If it is being administered properly, then there is no reason for the IRS to concern itself with what qualifies as "trust" or "per capita" in its Title 26 rulings.

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