

Up to \$124 million at stake in CDQs' bid for tax protection

Congressional committee estimates revenue cost of proposed legislation to shelter business activities

By Laurie McNicholas

Norton Sound Economic Development Corp. and the five other companies in the Western Alaska Community Development Quota Program are seeking an amendment to the federal tax code to make income from all of their business activities tax exempt.

If their legislative proposals become law, the government will forego from \$92 million to \$124 million in tax receipts in the next 10 years, according to a report issued last October by Thomas Barthold, chief of staff for the Joint Committee on Taxation. (See the letter from Barthold to Sens. Lisa Murkowski and Mark Begich on the next page.) The Joint Committee on Taxation prepares official revenue estimates of all tax legislation considered by the Congress.

All six CDQ companies are organized as non-profit Alaska corporations and have tax-exempt status with the Internal Revenue Service. However, an ongoing debate among executives of the companies and their financial and legal advisors centers on whether some business activities of the companies are beyond the scope of their tax-exempt status. Under federal law, trade or business activities not substantially related to the purposes for which an entity is granted tax-exempt status are subject to taxation.

To resolve the issue, last year the CDQ groups asked the Alaska Congressional delegation to sponsor legislation to specify the scope of their tax-exempt activities in an amendment to the Internal Revenue Code. On April 28 Sens. Murkowski and Begich submitted the initial tax code amendment proposal to the Joint Committee on Taxation on behalf of all six CDQs. The proposed legislation provides that business activities conducted by CDQ entities, including harvesting, processing, transportation, sales and marketing of fish or fish products are substantially related to the purposes on which their tax-exempt status is based.

NSEDC supports the initial proposal but did not participate with the other CDQ companies in its development. The proposal submitted to the Joint Committee on Taxation April 28 does not refer to wholly owned subsidiaries or to refunds of taxes paid on unrelated business income by subsidiaries of CDQ entities (issues important to NSEDC), so the company developed supplemental language to include such provisions. Sens. Murkowski and Begich submitted the supplemental language to the Joint Committee on Taxation on Oct. 15.

How tax issues evolved

The CDQ program was started in 1992 by the North Pacific Fishery Management Council to build sustainable fisheries-based economies in 65 communities within a 50-mile radius of the Bering Sea. The program later was included in the Magnuson-Stevens Fishery Conservation and Management Act.

The council allocated 7.5 percent of the annual Bering Sea pollock harvest quota to the program for harvest by the CDQ groups or fishing partners authorized by the companies in exchange for royalties. CDQ harvest royalties are not taxable. Later the annual CDQ pollock harvest quota was increased to 10 percent and the program received annual harvest quota allocations in other Bering Sea and Aleutian Islands fisheries.

Pollock royalties initially generated the majority of CDQ program revenues. Eventually the CDQ entities made substantial equity investments in fishing and processing operations in the Bering Sea/Aleutian Islands area. For example, in 1998 NSEDC bought a 50 percent ownership interest in Glacier Fish Co., which owned two factory trawlers and had harvested NSEDC's CDQ pollock since the program began.

In the early years of the program, only one of the six companies envisioned that some of its investment would be taxable. In 1992 the Aleutian Pribilof Island Community De-

velopment Association (APICDA) was granted tax-exempt status under Section 501(c)(3) of the Internal Revenue Code covering organizations operated exclusively for charitable and educational purposes, among others. APICDA formed two wholly owned for-profit subsidiaries in 1994.

"We structured ourselves in anticipation that income from our [for-profit] investments would be subject to unrelated business income tax," APICDA's Chief Executive Officer Larry Cotter said in a recent phone interview with *The Nome Nugget*. Currently the company has a dozen subsidiaries, all of which conduct activities that are subject to taxation, according to APICDA's 2008 annual report.

NSEDC, which represents 15 Bering Strait communities in the CDQ program, is among five CDQ companies that were granted tax-exempt status under section 501(c)(4) of the code as social welfare organizations in 1992. The other four are the Bristol Bay Economic Development Corp., the Central Bering Sea Fishermen's Association, the Coastal Villages Region Fund and the Yukon Delta Fisheries Development Association.

These five companies did not pay unrelated business income tax on

revenue from their Bering Sea equity investments that were directly owned by the parent nonprofit entity until 2007, according to a memorandum submitted with the proposed tax code amendment to the Joint Committee on Taxation by Sens. Murkowski and Begich on April 28.

"The consistent position taken by these groups until this time was that their income from the Bering Sea investments was substantially related to their exempt purpose and, therefore non-taxable," states the memorandum, which is addressed to legislative staff and dated March 31, 2009. The source of the memorandum is not identified.

In 2007 NSEDC consulted with legal advisors in Washington, D.C., and determined that income from some of its investments is taxable as unrelated business income. The company reportedly has paid \$8.1 million in back taxes, interest and penalties for the years 2005 through 2007, and about \$3 million for 2008 to the IRS. NSEDC also has paid state taxes for those periods. The company's tax liability for 2009 has not yet been made public. In 2008 NSEDC established a wholly owned for-profit subsidiary, Siu Alaska Corp., to hold taxable assets such as its investment

"I, frankly, was proud of them."

— APICDA's Larry Cotter on NSEDC's move to address tax issues

in Glacier Fish Co.

APICDA's Cotter praised NSEDC for its action. "I, frankly, was proud of them," he said.

Committee reports findings

On Oct. 21 Sens. Murkowski and Begich received a letter from Barthold describing the effects of the proposed legislation. He said it would exclude the revenues derived by CDQ companies from activities such as harvesting, processing, transportation, sales and marketing of fish or fish products from taxation as unrelated business income. His letter includes a table showing revenue estimates the government would forego in a 10-year period for the proposal with supple-

mental language (\$124 million) and for the proposal without supplemental language (\$92 million).

"We believe that some of the activities covered by your proposal could be found to be taxable under present law," Barthold wrote. "Therefore, your proposal results in less tax revenue in subsequent years. Furthermore, it is possible that the entities might expand their newly tax-exempt activities beyond current levels. To the extent that these entities compete with taxable entities, reducing taxable entities' profits, your proposal would indirectly reduce

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• CDQ taxes

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revenue from these taxable entities.

"Including the supplemental language, taxable subsidiaries wholly owned by CDQ entities could seek refunds and would pay less tax in subsequent years, until their assets are transferred back to the CDQ entities," Barthold continued. "Moreover, the supplemental language regarding the effective date results in a combination of refunds for previously paid tax and less collection of unpaid tax from previous years.

"For the purpose of this estimate, we assume that your proposal and supplemental language are effective on the date of enactment, except that with the supplemental language your proposal would apply retroactively as described above," Barthold noted. "We assume the date of enactment to be December 1, 2009." (The proposed legislation has not yet been introduced in Congress, according to CDQ entities and Congressional sources.)

CDQ executives comment

The *Nome Nugget* recently asked executives of three CDQ companies for their reactions to Barthold's letter. "I think we are going to continue to push for federal legislation to rectify the situation we are in right now," said Robin Samuelson, chief executive officer of the Bristol Bay Economic Development Corp. "Because we give scholarships and training, we should not be taxed," he added. "I think we fit the bill for a non-taxable group...." Samuelson said all six CDQ entities have met with members of the Alaska Congressional delegation and are working with them.

"I think it's a very heavy lift for our delegation to get this legislation through," commented APICDA's Cotter. Asked if he supports the proposals, he replied: "At this point in time, sure. At some point this issue needs to be resolved. We're gonna be a team player."

Cotter does not expect his company to benefit significantly from the supplemental language in the proposal, however. "We've only had to pay a minimal amount [of taxes] over the years," he said, explaining that APICDA has used net operating losses from some investments to defray profits from other investments. "None of our community investments ever make much money," he added. "Their losses are offset by revenues generated in non-community investments. Out-of-community investments generate large returns."

Cotter said if the supplemental language in the proposal is enacted, APICDA might get a tax refund of

less than six figures, NSEDC would be reimbursed for tax payments and the other four CDQ companies would not have to pay back taxes.

Dan Harrelson, NSEDC's president and board chairman, explained his company's reasons for submitting supplemental language for the proposed tax code amendment in an e-mail to the *Nugget*. "NSEDC has sought additional clarification in the legislative proposal that would bring certainty to the tax treatment of the CDQ groups for all periods, including past years, and that would put all the groups on an equal footing with respect to taxes if the principal CDQ tax amendment (developed by other groups) is enacted," Harrelson wrote. "We feel that this additional clarification would benefit all of the groups."

Harrelson also wrote: "...NSEDC supports the amendment and agrees that an amendment would be helpful to the CDQ sector as a whole, and Senators Murkowski and Begich and Congressman [Don] Young have told the CDQ groups that they believe the CDQ tax amendment is meritorious; however, it is our understanding that, due in part to the Congressional focus on the health care reform, no action is expected in the near future.

"If during the second session of the 111th Congress, the Alaska Delegation requests any additional support for the legislation we will certainly do our best to help move the tax package forward; there is no doubt that this additional income would be of great importance to the corporation and the projects and programs we're able

to administer. However, we would hope that your readers would be assured that NSEDC has taken a very proactive approach to protecting the corporation and its assets with respect to taxation and understand that we are completely confident that no matter the outcome of legislation that we're well-positioned for continued success in carrying out the important mission of the organization...."

CDQ program benefits

Samuelson chairs a six-member administrative panel composed of one representative from each CDQ entity—the Western Alaska Community Development Association. WACDA's 2008 CDQ program report provides the following summary of program benefits.

"At the program's inception in 1992, the 65 eligible villages faced discouraging circumstances, limited economic opportunities, underemployment, heavy reliance on subsistence activities, poverty rates far above state and national averages, and a daunting cost of living. Over the course of the past 16 years, the program has generated more than \$240 million in wages, payments to fishers, scholarships and training benefits. Additional benefits from the program accrue to local borough and state governments. In 2008, payments to individuals and communities totaled more than \$51 million."

In 2008 the six CDQ companies generated nearly \$190 million in revenue and had combined assets of \$427.6 million, according to the WACDA report.

Report sees some CDQ companies' activities as taxable

Editor's note: Following is the content of a letter from Thomas A. Barthold, chief of staff of the Joint Committee on Taxation, to Sens. Lisa Murkowski and Mark Begich in response to their request for a revenue cost estimate of proposed legislation to exempt certain business activities of the six Alaska Community Development Quota Program entities from federal taxation. The Nome Nugget obtained a copy of the letter, dated Oct. 15, 2009, from Sen. Murkowski's office.

The Joint Committee on Taxation is a nonpartisan Congressional committee originally established under the Revenue Act of 1926. It is composed of five members of the Senate Committee on Finance and five members from the House Committee on Ways and Means. The committee staff is closely involved in the tax legislative process, including preparing official revenue estimates of all tax legislation considered by the Congress.

The supplemental language Barthold describes below was added to the proposed legislation by Norton Sound Economic Development Corp., which represents 15 Bering Strait communities in the CDQ program.

"Dear Senator Murkowski and Senator Begich:

"This letter is in response to your request of April 28, 2009, for a revenue estimate of a proposal to specify the scope of tax-exempt activities of six Alaska Community Development Quota ('CDQ') program entities identified in section 305(i)(1)(D) of the Magnuson-Stevens Fishery Conservation and Management Act, as in effect on the date of enactment

of your proposal. Your proposal provides that certain business activities of the six entities undertaken in connection with their fisheries activities in Alaska are substantially related to the exercise or performance of the purposes constituting the basis of each entity's exemption from U.S tax under section 501(a) of the Internal Revenue Code (the 'Code').

"On October 15, you provided us with supplemental language specifying that these activities are also exempt from taxation when conducted by a taxable subsidiary that is wholly owned by a CDQ entity, provided that the activities would have been treated as related to the parent CDQ entity if conducted directly by the CDQ entity. The supplemental language also provides that, within 18 months after enactment, assets producing tax-exempt income may be transferred from such a subsidiary to the parent CDQ entity without taxable gain or income to either party. Furthermore, with the supplemental language, your proposal would apply with respect to a taxpayer for any taxable years for which a claim for credit or refund is not barred under section 6511 of the Code. You requested that we provide estimates both with and without this new language.

"We believe that some of the activities covered by your proposal could be found to be taxable under present law. Therefore, your proposal results in less tax revenue in subsequent years. Furthermore, it is possible that the entities might expand their newly tax-exempt activities beyond current levels. To the extent that these entities compete with taxable entities, reducing taxable entities' profits, your proposal would indirectly reduce revenue from these

Effect of proposals on federal fiscal year budgets

	Fiscal years											
	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2010-14	2010-19
A:	-40	-8	-8	-8	-9	-9	-10	-10	-11	-11	-73	-124
B:	-8	-8	-8	-8	-9	-9	-10	-10	-11	-11	-41	-92

Millions of dollars

A: Proposal with supplemental language

B: Proposal without supplemental language

taxable entities.

"Including the supplemental language, taxable subsidiaries wholly owned by CDQ entities could seek refunds and would pay less tax in subsequent years, until their assets are transferred back to the CDQ entities. Moreover, the supplemental language regarding the effective date results in a combination of refunds for previous paid tax and less collection of unpaid tax from previous years.

"For the purpose of this estimate, we assume that your proposal and supplemental language are effective

on the date of enactment, except that with the supplemental language your proposal would apply retroactively as described above. We assume the date of enactment to be December 1, 2009. The following table shows the effect of your proposals on Federal fiscal year budget receipts:

[See table above.]

"I hope this information is helpful to you. If we can be of further assistance in this matter, please let me know.

"Sincerely,
"Thomas A. Barthold"