MEMORANDUM

To: Barry Hart and Peter Hiebert

From: William L. Blum and Robert Ladislaw

cc: Jeffrey Epstein, Erika Kellerhals, Robert Solomon

Date: September 29, 2016

Subject: Structure for Avoidance of Repatriation Tax

We have been discussing potential means by which a large publically traded U.S. corporation ("US Corp"), with an Irish subsidiary ("ISub") which owns a substantial amount of cash, may arrange for the transfer of that cash to itself or its shareholders without the transfer being deemed a dividend which is subject to tax at full U.S. corporate rates (i.e., a "repatriation tax"). One proposed structure to potentially accomplish this is through the use of a trust. In addition to the goal of avoiding dividend treatment, the structure must provide the US Corp's directors with the ability to control the trustee in such manner that they may fulfill their fiduciary obligation to US Corp's shareholders to protect and preserve the assets of US Corp.

PROPOSED STRUCTURE

A possible structure would involve the establishment of a trust ("VI Trust") under the law of the U.S. Virgin Islands ("USVI"). ISub would be the grantor of VI Trust and would contribute cash to the trustee ("VI Trustee"). VI Trust will be structured to be a non-grantor trust for tax purposes (see below). It is proposed that the VI Trustee be a private trust company owned and controlled by US Corp. VI Trust would seek to qualify under a statutory program to be enacted in the USVI designed to create jobs in that territory as well as to enhance USVI tax and fee revenues ("VI Program"). Requirements and features of the VI Program would include the following with respect to VI Trust:

Minimum Initial Capitalization of $500 million.

Requirement that all or some substantial portion (say half) of the capital contributed to VI Trust remain in VI Trust for a minimum period of, say, five years, with the balance to be held for a minimum period of two years.

VI Trust, or a wholly owned disregarded LLC subsidiary of it, must create a business that employs at least 25 persons in the USVI of which at least 20 are persons who have resided in the USVI for at least one year (the "VI Business"). At least 50% of the required minimum number of jobs must be in computer programming, computer systems, or other jobs related to

technology, including a focus on services related to the licensing of intellectual property.

There will be a substantial application fee to participate in the VI Program in an amount to be determined.

VI Trust will be required to pay a substantial annual fee to the VI government for participation in an amount to be determined.

VI Trust will be required to make a certain amount of charitable contributions to local organized charities.

VI Trust will be exempt from the payment of USVI income taxes on any passive income that it earns to the maximum extent permitted by IRC section 934. This would include a 100% exemption on USVI source, or USVI effectively connected, interest, dividends, and capital gains. This creates an incentive to invest in USVI government obligations as well as in local USVI companies.

VI Trust will be 95% exempt from payment of USVI income tax on any income from the VI Business.

VI Trust will be exempt from the USVI gross receipts tax and other local taxes.

VI Trust may terminate its participation in the VI Program, and may close the VI business, at any time upon 90 days notice to the Government.

Should this occur within the first five years then a termination fee shall apply based on the remaining unpaid annual fee for the first five years, but there shall be no other penalty.

After the period during which VI Trust is required under the VI Program to maintain its minimum capital, VI Trust will make one or more distributions to its beneficiaries, which should consist mostly of non-taxable trust principal. The structure is designed to allow US Corp to take the position that this distribution should not be recharacterized as a dividend from ISub to US Corp.

ANALYSIS

There are several legal issues that have an impact on the viability of the above structure:

1. Establishment of a Trust by a Corporation

To proceed to establish the structure, Isub, a corporation, must be allowed to establish an entity that will be treated as a trust for tax purposes. While the grantor trust rules of IRC Sections 671-679 (Subpart E) are generally drafted using language which assumes

that an individual is the grantor of a trust, both Subpart E and the regulations thereunder recognize that a corporation may establish a trust and be its grantor.[1]

2. Treatment of VI Trust as a Non-grantor Trust

For the structure proposed above to succeed, VI Trust must have separate tax identity and not be disregarded. If VI Trust is treated as a grantor trust under the grantor trust rules of Subpart E of the IRC, then it will be disregarded for tax purposes with the result that when the cash distribution is made to US Corp it will be treated as a dividend from ISub and taxed accordingly in the United States.

The grantor trusts rules generally make it difficult for a trust to be treated as other than a grantor trust. But there are special rules for foreign grantors that make it less difficult for a foreign person to establish a non-grantor trust. Pursuant to IRC Section 672(f), Subpart E will **not** result in foreign ownership of a trust (i.e.. the trust will not be a grantor trust) unless one of two specific conditions exist:

[1] *See, e.g.,* IRC § 672(f)(1) and Treas. Reg. § 1.671-2(e)(4).

The foreign grantor will be treated as the owner of the trust (i.e., the trust is disregarded) if the foreign grantor retains the power to revest in itself absolutely title to the trust property without the approval or consent of any other person or with consent of a related or subordinate party who is subservient to the grantor.[2]

The foreign grantor will be treated as the owner of the trust if the only amounts distributable from the trust during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.[3]

We would expect that, with proper drafting, it can be assured that these conditions will not be permitted to exist. First, VI Trust should be made irrevocable by Isub and its beneficiary would not be Isub - rather it will be US Corp or its shareholders. Therefore, VI Trustee would not be permitted to re-vest title to the cash back into ISub. Second distributions from VI Trust would be for the benefit of US Corp or its shareholders, and not ISub, so distributions of income or principal from VI Trust to ISub would not be

---

[2] IRC § 672(f)(2)(A)(i).

[3] IRC § 672(f)(2)(A)(ii).

permitted. Therefore, subject to the discussion below, VI Trust should be treated as a non-grantor trust under Subpart E.

In the event of an examination, the IRS might also take the position that VI Trust should be treated as a trust or as a corporate subsidiary of ISub.[4] Therefore, it will be critical that the trust not be considered "a voluntary association of persons for convenience and profit."[5] So long as ISub creates VI Trust, unilaterally assigns beneficial interests in the trusts, and restricts the beneficiaries from transferring their interests in VI Trust, the IRS should not have a strong position on which to build a case that VI Trust should be treated as corporation for U.S. tax purposes.[6]

In addition, also to avoid characterization of VI Trust as a corporation, the governing instrument of VI Trust will be drafted to deny the trustees the power to "vary the investment of the certificate holders," so that VI Trust will not be treated as an "investment trust."[7]

---

[4] *See* Treas. Reg. § 301.7701-4(b).

[5] *See, e.g.,* Estate of Bedell v. [redacted], 86 T.C. 1207 (1986).

[6] *Id. See also* Water Res. Control v. [redacted], 61 TCM 2102 (1991).

[7] *See* Treas. Reg. § 301.7701-4(c).

3. Possible IRS Challenge to the Character of Trust or Distribution Based on Business Purpose, Sham, or Step Transaction

Treasury Regulation § 1.671-2(e)(4) states in part:.

> [I]f a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust.

Based on the above regulation, the IRS could be expected to challenge the characterization of the trust as a non-grantor trust unless US Corp or ISub could show a valid business purpose for the transfer of the cash from ISub into VI Trust. If the IRS were successful, then VI Trust's grantor would be deemed to be US Corp. If US Corp, a domestic corporation, were the grantor, then VI Trust would be characterized as a grantor trust under Subpart E.

Similarly, even without the above regulation, based on a "sham" argument, and/or the step transaction principal, the IRS could challenge the characterization of distributions by VI Trust to its beneficiaries as mere trust distributions. Rather the IRS could, under either of these theories, seek to characterize them as taxable dividends instead.

The response to such attempts at recharacterization by the IRS is to show a valid non-tax business purpose for the structure. If a legitimate business purpose can be shown, the adverse consequences of the cited regulation would be explicitly avoided as well as the sham argument. To counter the sham transaction argument, US Corp could point out that by the enactment of the VI Program, the USVI had effectively invited it to assist the USVI with its economic development by participating in the VI Program, a program enacted by the VI with this very purpose and which provides Congressionally authorized tax benefits under IRC section 934. US Corp would argue that, as a business matter, ISub decided to accept the invitation, and that its participation in the VI Program and establishment of the VI Business has a number of business benefits aside from the avoidance of U.S. taxes and that this should result in the conclusion that there was economic and business substance justifying the establishment of the structure and the transfers of funds. These include: lower tax rates on a portion of its passive income as well as with respect to the profit it earns on the VI Business, enhancement of its corporate reputation by investing in the USVI and in assisting with the economic

development of the USVI (an economically disadvantaged part of the United States), and moving assets to a jurisdiction that is under the U.S. flag which, unlike Ireland, provides it with the protections of U.S. investment treaties and other non-tax treaties. Additional business purpose arguments could relate to the need and desire of ISub to train USVI employees in technology and intellectual property related jobs.

An additional sham-related argument that could be used to attack the structure is that because US Corp controls both VI Trustee and ISub, the trust should be disregarded. This argument would be based on the common law concept that ownership interests in a trust must have two separate parts -- legal control by a trustee, coupled with benefit enjoyment by beneficiaries; if these two elements are combined, the argument goes, then there is no trust. The response to this argument is that there are at least three different entities relating to the trust – ISub, as grantor; VI Trustee, as trustee; and US Corp or its shareholders, as beneficiary -- and the fact that there is common control of these entities is insufficient under USVI law, to avoid characterization of the entity as a trust for state law (or tax law) purposes.[8]

The step transaction argument that could be made by the IRS amounts to an assertion that the steps involved in establishing the structure, and ultimately making the

[8] Legislation would be enacted in the USVI specifically addressing this issue.

distribution to US Corp, should be ignored and collapsed as without substance and for the reason that they were only designed to avoid the payment of tax on a dividend distribution to US Corp. The response to this argument would include the business purpose arguments described immediately above, and that there was some risk involved in participating in the VI Program, that the steps took place over a long period of time (five years) and that there was no assurance that all of the steps would necessarily take place.

CONCLUSION

Aspects of the proposed structure could potentially be challenged by the IRS leading to a conclusion that it is not viable if seen through to the point at which there is a repatriation of funds to the United States. If analyzed on that basis, the possibility that the repatriation could lead to taxation of the distribution as a dividend could make participation unattractive to companies in the position of US Corp.

However, even if the risk of adverse tax treatment exists, companies which might want to participate in the VI Program could have a different goal in mind. There have been many years of speculation that Congress may reduce the tax rate on dividends that

must be paid upon repatriation of funds by companies such as US Corp. If Congress becomes aware that the VI Program might actually permit companies to repatriate at a zero tax rate, it may be more inclined to enact legislation to reduce the corporate dividend rate (albeit likely not to zero) to make repatriation more palatable. In this context, the VI Program could be viewed as a method to try to force Congress's hand in this regard. On the flip side, should this not occur, a participant in the VI Program could always back out. This could occur either because Congress acts to reduce the repatriation tax rate and the participant would rather take advantage of the lower rate without the uncertainty of the tax consequences of the VI Program, or where Congress does not act but the participant later decides that it does not wish to do battle with the IRS. In either case, the cost of participation in the VI Program is not so high that this would be an unreasonable future course of action.