articles. That is, when manufactured articles qualifying for drawback are commingled with nonqualifying articles after the former are manufactured by a drawback claimant, substitution under the law is not authorized. In such situations, identification of merchandise or articles for drawback purposes by accounting procedures must be revenue neutral or favorable to the Government and the accounting procedures should be consistent with the criteria for such accounting procedures described above.

Comment: The drawback law does not require any method of identifying fungible duty-paid imported materials which may be commingled in storage with other foreign or domestic materials; rather, the law delegates authority to the Secretary of the Treasury to prescribe appropriate accounting methods by regulation.

Response: Section 1313(l) of the drawback law provides that the allowance of drawback shall be subject to compliance with such rules and regulations as the Secretary of the Treasury shall prescribe. Under this authority, the agency has already prescribed, *inter alia*, a regulation governing the use of accounting methods (see, 19 CFR 191.22(c)). As stated above, the final interpretative ruling articulates Customs position that in situations where the law does not specifically authorize substitution, identification of merchandise or articles for drawback purposes by appropriate accounting procedures should be consistent with the criteria for such accounting procedures described above.

Comment: The higher-to-lower accounting method promotes administrative efficiency because it allows Customs to verify drawback claims without inquiring as to the order of withdrawal from commingled inventory.

Response: The drawback statute contains specific time limits (see *e.g.*, sections 1313 (i), (b), (c), (j), (p)). Any verification by Customs of whether a drawback claimant has complied with the drawback law and the regulations issued thereunder must include verification that the statutory time-limits were met.

Comment: If Customs decides to revoke C.S.D. 84–82 and proscribe the use of higher-to-lower accounting for drawback, Customs should specify a ''cut-off'' date for use of the higher-to-lower method. Customs should delay the effective date for this change in position because the drawback public may have relied on this ruling in establishing its inventory methods for drawback. One commenter suggests an implementation period of 3 years.

Response: Customs is delaying the effective date of the amendment of T.D. 84–49 and the revocation of C.S.D. 84–82 for 90 days after the publication of this document, the maximum delay provided for in the Customs Regulations for a modification or revocation of a ruling (see 19 CFR 177.9). Customs notes that, in regard to manufacturing drawback, a drawback claimant which relied on C.S.D. 84–82 should be able to document such reliance in its drawback rate (*i.e.*, in order to be paid manufacturing drawback, a claimant must have an approved drawback rate (see 19 CFR 191.23 and the general drawback rate for section 1313(a) (T.D. 81–234), as well as the sample drawback proposal for section 1313(b) provided for in 19 CFR 191.21(c), the latter of which contains specific sections in which the claimant is instructed to describe its inventory procedures)). In such instances (*i.e.*, when a claimant is operating under a drawback rate which specifically provides for higher-to-lower accounting), drawback claimants may continue to use higher-to-lower accounting procedures, as provided for in their drawback rates, until their rates are modified, and notice of the modification is sent to the rate holders.

Conclusion

For the reasons given in the June 28, 1994, **Federal Register** notice, and following careful consideration of the comments received and further review of the matter, Customs is taking the actions described in the June 28, 1994, **Federal Register** notice. That is:

1. T.D. 84–49 is amended to permit the accounting for withdrawals from inventory of exports and drawback deliveries on a FIFO basis. The order of such withdrawals will continue to be: first exports, then drawback deliveries, after which domestic shipments will be accounted for on a FIFO basis.

2. C.S.D. 84–82 is revoked.

This amendment of T.D. 84–49 and the revocation of C.S.D. 84–82 will be effective to drawback entries or claims properly filed with Customs on or after 90 days from the date of publication in the **Federal Register**. Drawback claimants operating under properly approved drawback rates under 19 CFR 191.23 may continue to claim drawback using higher-to-lower accounting procedures, as provided for in C.S.D. 84–82, if the drawback rates under which they are operating specifically provide for the use of such procedures, until such rates are modified, and notice of such modification is sent to the rate holders.

Michael H. Lane,

Acting Commissioner of Customs.

Approved: July 6, 1995.

John P. Simpson,

Deputy Assistant Secretary of the Treasury.

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Internal Revenue Service

26 CFR Parts 1 and 602

[TD 8611]

RIN 1545–AS40

Conduit Arrangements Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to conduit financing arrangements issued under the authority granted by section 7701(l). The final regulations apply to persons engaging in multiple-party financing arrangements. The final regulations are necessary to determine whether such arrangements should be recharacterized under section 7701(l).

EFFECTIVE DATE: The regulations are effective September 11, 1995.

FOR FURTHER INFORMATION CONTACT: Elissa J. Shendalman of the Office of the Associate Chief Counsel (International), (202) 622–3870 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545–1440. The estimated annual burden per recordkeeper is 10 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On August 10, 1993, Congress enacted section 7701(l) of the Internal Revenue Code (Code), which authorizes the

Secretary to ''prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more parties where such recharacterization is necessary to prevent avoidance of any tax imposed by [title 26].'' The legislative history to section 7701(l) noted with approval a series of tax court and IRS pronouncements that used ''substance over form'' principles to recharacterize conduit financing arrangements, but stated that the Secretary was not bound by the principles of these pronouncements in developing regulations.

On October 14, 1994, the IRS published a notice of proposed rulemaking in the **Federal Register** (59 FR 52110) under section 7701(l) of the Code. These proposed regulations permit the district director to disregard the participation of one or more intermediate entities in a conduit financing arrangement for purposes of sections 871, 881, 1441, and 1442.

Written comments responding to the notice were received, and a public hearing was held on December 16, 1994. After considering the written comments received and the statements made at the hearing, the IRS and Treasury adopt the proposed regulation as revised by this Treasury decision.

Explanation of Provisions and Summary of Significant Comments

A. Overview of Provisions

The final regulations make few substantive changes to the proposed regulations. Most changes are in the nature of refinements to, and clarifications of, the principles in the proposed regulations. It should be noted that the IRS and Treasury will continue to monitor conduit financing arrangements in the context of sections 871, 881, 1441 and 1442 after the publication of these final regulations. If the rules announced herein do not sufficiently address the avoidance of these taxes, the IRS and Treasury will consider modifying or supplementing these rules as they find necessary.

Section 1.881–3(a)(2) of the final regulations provides definitions of certain terms used throughout the regulations. A *financing arrangement* is defined as a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or the right to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity. The final regulations supplement this basic rule with an anti-abuse rule that allows the IRS to treat related persons as a single entity where a taxpayer interposes a related person in an arrangement that would otherwise qualify as a *financing arrangement* to circumvent the application of the conduit rules.

A *financing transaction* includes a debt instrument, lease or license. In addition, an equity instrument may qualify as a *financing transaction* if the equity has certain debt-like characteristics. The term *financing transaction* also includes any other advance of money or property pursuant to which the transferee is obligated to repay or return a substantial portion of the money or other property advanced or the equivalent in value.

Section 1.881–3(a)(3)(i) authorizes the district director to determine that an intermediate entity is a conduit entity under the rules set forth in § 1.881–3(a)(4). Section 1.881–3(a)(3)(ii) describes the effects of conduit treatment. Section 1.881–3(a)(3)(ii)(B) generally provides that the character of the payments made under the recharacterized transaction (i.e. interest, rents, etc.) is determined by reference to the character of the payments made to the financing entity. However, if the financing transaction to which the financing entity is a party gives rise to a type of payment that would not be deductible if paid by the financed entity (e.g., dividends, as determined under U.S. tax principles), the character of the payments is not affected by the recharacterization.

Section 1.881–3(a)(3)(ii)(E) provides that a financing entity that is unrelated to both the intermediate entity and the financed entity is not liable for the tax imposed by section 881 unless it knows or has reason to know of a conduit financing arrangement. Moreover, the final regulations create a presumption that an unrelated financing entity does not know or have reason to know of a conduit financing arrangement where the intermediate entity that is a party to the financing transaction with the financing entity is engaged in a substantial trade or business.

Section 1.881–3(a)(4) provides the standards for determining whether an intermediate entity is a conduit entity for purposes of section 881. If an intermediate entity is related to either the financing entity or the financed entity, the intermediate entity will be a conduit entity only if (i) the participation of the intermediate entity in the financing arrangement reduces the U.S. withholding tax that otherwise would have been imposed, and (ii) the participation of the intermediate entity in the financing arrangement is pursuant to a plan one of the principal purposes of which is the avoidance of the withholding tax.

If a financing arrangement involves multiple intermediate entities, § 1.881–3(a)(4)(ii)(A) provides that the district director will determine whether each of the intermediate entities is a conduit entity. The factors, presumptions, and other rules in the regulations generally state how they should be applied in the case of multiple intermediate entities. The regulations state that, if no such rule is provided, the district director should apply principles consistent with the standards described above. Section 1.881–3(a)(4)(ii)(B) provides a general anti-abuse rule that allows the district director to treat related intermediate entities as a single intermediate entity if he determines that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent the provisions of this section. The district director's determination is to be based upon all of the facts and circumstances, including, but not limited to, the factors indicating whether the intermediate entity's participation in a financing arrangement is pursuant to a tax avoidance plan.

Section 1.881–3(b) provides that the district director will weigh all available evidence regarding the purposes for the intermediate entity's participation in the financing arrangement. Moreover, § 1.881–3(b)(3) provides a presumption that a tax avoidance plan does not exist where an intermediate entity that is related to either the financing entity or the financed entity performs significant financing activities with respect to the financing transactions making up the financing arrangement.

In the case of an intermediate entity that is not related to either the financing entity or the financed entity, the intermediate entity will not be a conduit entity unless the requirements applicable to related parties are met (that is, there is a reduction in the tax imposed by section 881 and a tax avoidance plan) and, in addition, the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity advanced money or property to (or entered into a lease or license with) the intermediate entity. See § 1.881–

3(a)(4)(i)(C). Under § 1.881–3(c)(2), the district director may presume that the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the financing transaction between the financing entity and the intermediate entity if another person has provided a guarantee of the financed entity's obligation to the intermediate entity. The term *guarantee* includes, but is not limited to, a right of offset between the two financing transactions to which the intermediate entity is a party.

Once the district director has disregarded the participation of a conduit entity in a conduit financing arrangement, § 1.881–3(d)(1)(i) provides that a portion of each payment made by the financed entity is recharacterized as a payment directly between the financed entity and the financing entity. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, the entire amount of the payment by the financed entity shall be recharacterized. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is greater than the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, then the recharacterized portion shall be determined by multiplying the payment by a fraction the numerator of which is equal to the lowest aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement and the denominator of which is the aggregate principal amount of the financing transaction(s) to which the financed entity is a party.

Under § 1.881–3(d)(1)(ii)(A), the principal amount of a financing transaction generally equals the amount of money, or the fair market value of other property, advanced, or subject to a lease or license, valued at the time of the financing transaction. However, in the case of a financing arrangement where the same property is advanced, or rights granted from the financing entity through the intermediate entity (or entities) to the financed entity, the property is valued on the date of the last financing arrangement. This rule is intended to minimize the distortive effect of currency or other market fluctuations when there is a time lag between financing transactions. In addition, the principal amount of certain types of financing transactions is subject to adjustment. Sections 1.881–3(d)(1)(ii) (B) through (D) provide more detailed guidance regarding how these general rules are applied to different types of financing transactions.

Section 1.881–4 uses the general recordkeeping requirements under section 6001 to require a financed entity or any other person to keep records relevant to determining whether such person is a party to a financing arrangement and whether that financing arrangement may be recharacterized under § 1.881–3. Corporations that otherwise would report certain information on total annual payments to related parties pursuant to sections 6038(a) and 6038A(a) must also maintain such records where the corporation knows or has reason to know that such transactions are part of a financing arrangement. Specifically, the final regulations require the entity to retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrangements, including minutes of board of directors meetings and board resolutions and materials from investment advisors regarding the structuring of the transaction.

Under § 1.1441–7(d), any person that is a withholding agent for purposes of section 1441 with respect to the transaction (whether the financed entity or an intermediate entity that is treated as an agent of the financing entity) must withhold in accordance with the recharacterization if it knows or has reason to know that the financing arrangement is a conduit financing arrangement. The final regulations provide examples of how the ''knows or has reason to know'' standard, which generally applies to all withholding agents, is to be applied in this context.

B. Discussion of Significant Comments

Significant comments that relate to the application of the proposed regulation and the responses to them, including an explanation of the revisions made to the final regulation, are summarized below. Technical or drafting comments that have been reflected in the final regulations generally are not discussed.

1. General Approach

As described above, the final regulations adopt the general ''tax avoidance'' standard of the proposed regulations. Several commentators criticized the proposed regulations for setting forth new standards for the recharacterization of conduit transactions. They argued that the rulings that preceded these regulations required matching cash flows from the financed entity to the conduit entity and from the conduit entity to the financing entity. Some commentators argued that, because in their view the regulations adopt new standards, the regulations should only be effective for transactions entered into after the enactment of section 7701(l), while others argued that the regulations should only apply to transactions entered into after the publication of the final regulations. Finally, some commentators suggested that the regulations constituted an override of our treaty obligations and might therefore be invalid.

The IRS and Treasury believe that pre-section 7701(l) conduit rulings rested on a taxpayer having a tax avoidance purpose for structuring its transactions. The fact that an intermediate entity received and paid matching, or nearly matching, cash flows was evidence that the participation of the intermediate entity in the transaction did not serve a business purpose. Nevertheless, the fact that cash flows were not matched did not mean that the transaction had a business purpose.

The final regulations generally apply to payments made by financed entities after the date which is 30 days after the date of publication of the regulations because the IRS and Treasury believe that the regulations reflect existing conduit principles. Moreover, even if the regulations had adopted a new standard, it would be inappropriate to grandfather transactions that admittedly had a tax avoidance purpose. The final regulations do not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation). Prior law continues to apply with respect to payments on any such debt instruments.

As noted in the preamble to the proposed regulations, the IRS and Treasury believe that these regulations supplement, but do not conflict with, the limitation on benefits articles in tax treaties. They do so by determining which person is the beneficial owner of income with respect to a particular financing arrangement. Because the financing entity is the beneficial owner of the income, it is entitled to claim the benefits of any income tax treaty to which it is entitled to reduce the amount of tax imposed by section 881 on that income. The conduit entity, as an agent of the financing entity, cannot claim the benefits of a treaty to reduce the amount of tax due under section 881

with respect to payments made pursuant to the financing arrangement.

2. Discretion given to District Director

a. *Determination of whether conduit entity's participation will be disregarded.* Because the proposed regulations utilize a tax avoidance test that depends on the facts and circumstances, discretion is given to the district director to determine whether the participation of an intermediate entity had as one of its principal purposes the avoidance of U.S. withholding tax. Among other things, the district director may determine the composition of the financing arrangement and the number of parties to the financing arrangement.

Some commentators criticized this grant of discretion because they claimed that the regulations provide insufficient guidance regarding what factors the district director should take into account. Several commentators proposed adding presumptions, making certain existing presumptions irrebuttable or otherwise providing bright-line tests. One commentator suggested that the district director's discretion to determine the parties to a financing arrangement should be limited to the extent necessary to ensure that a taxpayer could prove that a different party that was entitled to treaty benefits was the real financing entity. Finally, another commentator suggested that the determination whether an intermediate entity's participation will be disregarded should be subject to review by a central control board in the National Office of the IRS.

Because the final regulations retain the facts and circumstances test used in the proposed regulations, the final regulations do not significantly reduce the district director's discretion. As discussed below, it was not considered necessary to add additional factors because the objective list of factors is not exclusive. The final regulations do, however, provide more guidance regarding the tax avoidance purpose test by adding several more examples. In addition, the final regulations modify the factor relating to whether there has been a significant reduction in tax to allow the taxpayer to produce evidence that there was not a reduction in tax because the entity that was the ultimate source of funds also was entitled to treaty benefits. See § 1.881–3(b)(2)(i).

The final regulations do not adopt the suggestion that the district director's discretion be subject to review at the National Office level. The final regulations, like the proposed regulations, provide that the determination of whether a tax avoidance plan exists is based on all of the facts and circumstances surrounding the intermediate entity's participation in the financing arrangement. The IRS and Treasury believe that such a determination would best be made at the local level.

b. *Judicial standard of review.* Because the district director is granted discretion by the regulations, his determinations generally will be reviewed by the court under an abuse of discretion standard. Commentators suggested that the district director's determination that an intermediate entity's participation should be disregarded should be reviewed by the court under this standard. One commentator instead suggested that courts review a district director's determination using a de novo standard of review. Another suggested that the IRS should be afforded only its normal presumption of correctness. The final regulations do not adopt these suggestions because they are fundamentally inconsistent with the grant of discretion to the district director.

3. Definitions

a. *Financing transaction, in general.* Commentators pointed out that thedefinition of *financing transaction* in the proposed regulations encompassed transactions that clearly were not meant to be covered by the proposed regulations. For example, under the proposed regulations, a foreign parent that contributed an existing note from its domestic subsidiary to a foreign subsidiary in exchange for common stock of the subsidiary that did not have any debt-like features nevertheless would be treated as a financing entity because the foreign parent had made an advance of property (the note) pursuant to which the foreign subsidiary had ''become a party to an existing financing transaction''.

The definitions of *financing transaction* and *financing arrangement* have been redrafted to address these concerns. See § 1.881–3(a)(2) (i) and (ii). The effect of the new definitions is to take a ''snapshot'' after all the transactions are in place to determine whether there is a *financing arrangement.*

b. Equity. Commentators noted that the proposed regulations were inconsistent in their treatment of how a controlling interest in a corporation, either before or after a default, affected whether an equity arrangement was a financing transaction. In addition, commentators requested that the final regulations explicitly exempt ''common stock'' and ''ordinary preferred stock'' from treatment as financing transactions.

In response to the first of these comments and in a general attempt to clarify the types of equity instruments that are financing transactions, the final regulations revise the definition of *financing transaction* with respect to equity. See § 1.881–3(a)(2)(ii) (A)(*2*) and (B). The new definition provides that the right to elect the majority of the board of directors will not, in and of itself, cause an equity instrument to be a financing arrangement. See § 1.881–3(a)(2)(ii)(B)(*2*)(*i*).

As to the second suggestion, the final regulations do not create a separate exception from the definition of financing transaction for ''common stock'' or ''ordinary perpetual preferred stock.'' Whether a transaction constitutes a financing transaction depends upon the terms of the transaction, not simply on the label attached to the transaction. Moreover, because these terms are not themselves well-defined in either the Code or common law, the IRS and Treasury believe that excluding these categories of instruments would lead to disputes as to whether a particular instrument is ''common stock'' or, if not, whether it is ''ordinary'' perpetual preferred stock.

c. Guarantees. Commentators asked that final regulations explicitly provide that guarantees are exempted from treatment as financing transactions. The IRS and Treasury believe that the new definition of financing transaction, which does not treat becoming a party to a financing transaction as itself a financing transaction, clarifies that a guarantee is not a financing transaction. Moreover, the final regulations add an example to eliminate any doubt in this regard. See § 1.881–3(e) *Example 1.*

d. Leases and licenses. The proposed regulations provide that leases and licenses are financing transactions. Some commentators suggested that the regulations not include leases and licenses in the definition of financing transaction or that the IRS reserve on the subject of leases until it had more time to study the matter.

Other commentators proposed that certain types of leases, for instance short-term leases and leveraged leases, be excluded from the definition of financing transaction. The commentators pointed out that certain leveraged leases would be subject to recharacterization under the proposed regulations even though, in substance, the financing arrangement is the equivalent of a loan from a financing entity entitled to a zero rate of withholding on interest. Under § 1.881–3(d)(2) of the proposed regulations,

which provides that the nature of the recharacterized payments is determined by reference to the transaction to which the financed entity is a party, the participation of the intermediate entity in a leveraged lease would substantially reduce the tax imposed under section 881 if the treaty between the United States and the country in which the lender was organized allowed withholding on rental payments. Because all of the negative factors of § 1.881–3(c)(2) and the ''but-for'' test of § 1.881–3(b) of the proposed regulations are met in a standard leveraged lease, this reduction in tax would allow the district director to recharacterize the financing arrangement as a conduit financing arrangement.

The IRS and Treasury believe that all leases and licenses, of whatever duration, can be used by taxpayers to structure a conduit financing arrangement. Accordingly, the final regulations continue to include leases and licenses in the definition of financing transaction. See § 1.881–3(a)(2)(ii)(A)(*3*). However, the final regulations change the character rule in the case of deductible payments. In those cases, the character of the payments under the recharacterized transaction is determined by reference to the financing transaction to which the financing entity is a party. As a result, under the final regulations, a leveraged lease generally will not be recharacterized as a conduit arrangement if the ultimate lender would be entitled to an exemption from withholding tax on interest received from the financed entity, even if rental payments made by the financed entity to the financing entity would have been subject to withholding tax.

e. Related. As noted above, it is more difficult for an intermediate entity to be a conduit entity if it is not related to either the financing entity or the financed entity. The definition of persons who are *related* to another person generally follows the definition used in section 6038A. One commentator suggested that the final regulations eliminate the constructive ownership rule of section 267(c)(3) from the definition of related. The same commentator further suggested that a person under common control within the meaning of section 482 should not be a related person for purposes of this regulation.

The IRS and Treasury believe that the term *related* should be broadly defined to ensure that the additional protection from recharacterization provided by the so-called ''but for'' test flows only to those entities that are not under the effective control of either the financing or the financed entity. Accordingly, the final regulations retain the definition of related provided in the proposed regulations. See § 1.881–3(a)(2)(v).

4. Factors Indicating the Presence or Absence of a Tax Avoidance Plan

a. In general. The proposed regulations provide that whether the participation of the intermediary in the financing arrangement is pursuant to a tax avoidance plan is determined based on all the relevant facts and circumstances. In addition, the proposed regulations provide a list of some of the factors that will be taken into account: the extent of the reduction in tax; the liquidity of the intermediate entity; the timing of the transactions; and, in the case of related entities, the nature of the business(es) of such entities.

Commentators asked that the final regulations adopt a number of additional factors. For example, commentators asked that the dissimilarity of cash flows or of financing transactions making up the financing arrangement constitute a positive factor (i.e., a factor that evidences the absence of a tax avoidance plan). Commentators also suggested that the positive factors include the fact that income was subject to net tax in the United States or in a foreign jurisdiction or, alternatively, that the transaction reduced other U.S. or foreign taxes more than it reduced the U.S. withholding tax (indicating that the purpose of the transaction was to avoid taxes other than the tax imposed by section 881).

The factors proposed by commentators generally relate to the issue of whether there were purposes, other than the avoidance of the tax imposed by section 881, for the participation of the intermediate entity in the financing arrangement. The final regulations do not add factors relating to purposes for the participation of an intermediate entity in a financing arrangement. However, § 1.881–3(b)(1) of the final regulations addresses the issue by clarifying that the district director will consider all available evidence regarding the purposes for the participation of the intermediate entity.

b. Factor relating to a complementary or integrated business. One of the factors listed in the proposed regulations is whether, if the intermediate entity is related to the financed entity, the two parties enter into a financing transaction to finance a trade or business actively engaged in by the financed entity that forms a part of, or is complementary to, a substantial trade or business actively engaged in by the intermediate entity. One commentator expressed uncertainty as to the policy behind this factor.

The intent of this factor was to take into account the fact that related corporations engaged in integrated businesses may enter into many financing transactions in the course of conducting those businesses, the vast majority of which have no tax avoidance purpose. Accordingly, § 1.881–3(b)(2)(iv) of the final regulations clarifies that the district director will take into account whether a transaction is entered into in the ordinary course of integrated or complementary trades or businesses in determining whether there is a tax avoidance plan. In addition, the factor is broadened so as to apply not only to transactions between the intermediate entity and the financed entity but to transactions between any two parties to the financing arrangement that are related to each other.

5. Presumption Regarding Significant Financing Activities

The proposed regulations provide that, in the case of an intermediate entity that is related to either the financing entity or the financed entity, a presumption of no tax avoidance arises where the intermediate entity performs significant financing activities for such entities. Among other things, the provision required employees of the intermediate entity (other than an intermediate entity that earned ''active rents'' or ''active royalties'') to manage ''business risks'' arising from the transaction on an ongoing basis. The proposed regulations provide an example showing that, if there are no such business risks because the intermediate entity has hedged itself fully at the time it entered into the financing transactions, the entity is not described in the provision.

One commentator criticized the articulation of the significant financing activities presumption in the proposed regulations on the grounds that the test should be solely whether the participation of the intermediate entity produces (or could be expected to produce) efficiency savings through a reduction in overhead costs and the ability to hedge the group's positions on a net basis. Another commentator proposed extending the presumption for significant financing activities to intermediate entities that are unrelated to both the financed entity and the financing entity.

As to the first comment, the IRS and Treasury agree that there is not a sufficient business purpose for the centralization of financing activities of a group of related corporations in a single

corporation unless the taxpayer anticipates efficiency savings. Although the prospect of such savings in general may establish a business purpose for the establishment of the subsidiary, it does not prevent the subsidiary from acting as a conduit with respect to any particular financing arrangement. This is demonstrated by the hedging example described above, the rationale for which is that either the financed entity or the financing entity could have entered into the long-term hedge so there is no economic justification for the participation of the intermediate entity in the particular financing arrangement. The IRS and Treasury believe that an affiliate that is not taking a continuing active role in coordinating and managing a financing transaction should not be entitled to the presumption that its participation is not pursuant to a tax avoidance plan.

As to the suggestion of extending the significant financing activities presumption to unrelated parties, the IRS and Treasury believe that this extension would be inconsistent with the purpose of the presumption. The significant financing presumption recognizes that there are legitimate business reasons for conducting financing activities through a centralized financing and hedging subsidiary. The decision to have an unrelated intermediate entity participate in a financing transaction is based on different considerations, including the regulatory effects of such transactions and the interests of the shareholders of the unrelated intermediary. These considerations are addressed by providing that such entities will not be conduit entities unless they satisfy the ''but for'' test. The final regulations do not extend the significant financing activities presumption to unrelated parties.

Accordingly, the requirements for the significant financing activities presumption in § 1.881–3(b)(3) of the final regulations are generally the same as those in the proposed regulations. However, the final regulations do add a requirement that the participation of the intermediate entity generate efficiency savings, and change the term *business risks* to *market risks* (to differentiate the risks of currency and interest rate movements from other, primarily credit, risks). In addition, one of the examples that illustrates the significant financing activities presumption has been revised to indicate that a finance subsidiary may be managing market risks even in the case of a fully-hedged transaction if the intermediate entity routinely terminates such long term arrangements when it finds cheaper hedging alternatives. See § 1.881–3(e) *Example 22.*

6. ''But for'' Test

a. In general. Under the proposed regulations, if the intermediate entity is not related to either the financing entity or the financed entity, the financing arrangement will not be recharacterized unless the intermediate entity would not have participated in the financing arrangement on substantially the same terms ''but for'' the fact that the financing entity advanced money or property to (or entered into a lease or license with) the intermediate entity.

Commentators asked for clarification regarding what it means for terms to be not substantially the same. One commentator proposed using the standards for material modifications under section 1001.

The IRS and Treasury believe that an attempt to set forth a comprehensive system of bright-line rules like those suggested by commentators would add unnecessary complexity to the regulation, given its anti-abuse purpose. Accordingly, the final regulations make no change to the proposed regulations in this regard.

b. Presumption where financing entity guarantees the liability of the financed entity. Under the proposed regulations, it is presumed that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if, in addition to entering into a financing transaction with the intermediate entity, the financing entity guarantees the financed entity's liabilities under its financing transaction with the intermediate entity. A taxpayer may rebut this presumption by producing clear and convincing evidence that the intermediate entity would have participated in the financing arrangement on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity.

Several commentators asked for clarification of this presumption. Some commentators suggested that the existence of a guarantee makes the existence of the financing transaction between the financing entity and the intermediate entity irrelevant to the determination of whether the intermediate entity would have participated in the financing arrangement on substantially the same terms. Another commentator proposed eliminating the ''clear and convincing evidence'' standard on the grounds that it is too difficult an evidentiary burden for the taxpayer to overcome.

The presumption regarding guarantees originated in Rev. Rul. 87–89 (1987–2 C.B. 195), which articulated the ''but for'' test in substantially the same terms as adopted in the final regulations. Rev. Rul. 87–89 provided that a statutory or contractual right of offset is presumptive evidence that the unrelated intermediary would not have participated in the financing arrangement on substantially the same terms without the financing transaction from the financing entity. The proposed regulations extend the presumption to all guarantees in order to prevent taxpayers from using forms of credit support other than the right of offset to avoid this presumption. The final regulations retain this rule. See § 1.881–3(c)(2).

The final regulations also retain the ''clear and convincing evidence'' standard. The taxpayer always must overcome the presumption of correctness in favor of the government by a preponderance of the evidence. Therefore, in order for this additional presumption to have any effect, it is necessary to raise the evidentiary standard. In addition, this standard of proof is not unreasonable, because an intermediate entity that is unrelated to the financing entity and the financed entity and that proves, by clear and convincing evidence, that it would have entered into the financing arrangement on substantially the same terms will avoid recharacterization as a conduit entity *even though* its participation in the financing arrangement is pursuant to a tax avoidance plan.

7. Multiple Intermediate Entities

a. In general. The proposed regulations provide guidance as to how some but not all of the operative provisions and presumptions apply to multiple intermediate entities. Several commentators asked that the final regulations clarify the manner in which the operative rules apply in the case of multiple intermediate entities. The final regulations provide additional guidance in the relevant operative rules and presumptions. In addition, the final regulations modify the example in the proposed regulations relating to multiple intermediate entities to clarify how some of these provisions and presumptions apply. See § 1.881–3(e) *Example 8.*

b. Special rule for related persons. Section 1.881–3(a)(4)(ii)(B) of the proposed regulations allows the district director to treat related persons as a single intermediate entity if he determines that one of the principal purposes for the structuring of a transaction was the avoidance of the

application of the conduit financing arrangement rules. Several commentators suggested that the final regulations eliminate this section. One commentator suggested that the rule be limited to situations where one related corporation made an equity investment in another. Another believed that the IRS and Treasury should ''wait and see'' whether such a rule was really necessary to prevent taxpayers from circumventing the conduit financing arrangement rules.

The IRS and Treasury believe that an anti-abuse rule is necessary to prevent the circumvention of these rules through manipulation of the definition of financing arrangement. Accordingly, § 1.881–3(a)(2)(i)(B) of the final regulations retains the related party anti-abuse rule. Moreover, the final regulations include another more general anti-abuse rule that allows the district director to treat related intermediate entities as a single intermediate entity if he determines that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an entity as a conduit, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent any other provision of this section. See § 1.881–3(a)(4)(ii)(B). This rule prevents a taxpayer from structuring a financing transaction with a small principal amount to reduce the amount of the recharacterized payment, and thus replaces the second half of the rule set forth in proposed regulation § 1.881–3(a)(4)(ii)(B). This rule is illustrated in § 1.881–3(e) *Example 7.*

8. Principal Amount

The proposed regulations provide that the principal amount of a financing transaction shall be determined on the basis of all of the facts and circumstances. Under the proposed regulations, the principal amount generally equals the amount of money, or the fair market value of other property (determined as of the time that the financing transaction is entered into), advanced in the financing transaction. The principal amount of a financing transaction is subject to adjustments, as appropriate.

Some commentators asked for clarification regarding whether adjustments would be made to the principal amount of a financing transaction to take account of amortization or depreciation. Another commentator suggested that the final regulations provide that calculations be performed in the functional currency of the intermediate entity in order to isolate currency fluctuations.

The final regulations provide that adjustments for depreciation and amortization are made when calculating the principal amount of a leasing or licensing financing transaction. See § 1.881–3(d)(1)(ii)(A).

Although the IRS and Treasury agree that the effect of currency fluctuations should be minimized, they believe that determining the principal amount in the functional currency of the intermediate entity would not always yield the correct result. Accordingly, the final regulations eliminate currency and market fluctuations to the extent possible by providing that, when the same property has been advanced by the financing entity and received by the financed entity, the determination of the principal amount is made as of the date the last financing transaction is entered into. See § 1.881–3(d)(1)(ii)(A). An example has been added to demonstrate how this rule applies to transactions in currencies other than the U.S. dollar. See § 1.881–3(e) *Example 25.*

9. Correlative Adjustments

The proposed regulations do not provide for correlative adjustments in the case of the district director's recharacterization of a financing arrangement as a transaction directly between a financing entity and a financed entity.

Commentators have requested that taxpayers be allowed to make correlative adjustments if their transactions are recharacterized. Commentators generally would not, however, allow the IRS to make correlative adjustments where such adjustments would result in greater tax liability.

The final regulations, like the proposed regulations, do not provide for correlative adjustments. The IRS and Treasury agree with commentators that it is not appropriate to use regulations that are intended to prevent the avoidance of tax under section 881 to recharacterize transactions for purposes of other code sections. Accordingly, taxpayers should not be able to use these regulations to make correlative adjustments to their tax returns.

10. Recordkeeping and Reporting Requirements

The proposed regulations require corporations that would otherwise report certain information on total annual payments to related parties pursuant to sections 6038(a) and 6038A(a) to report such information on a transaction-by-transaction basis where the corporation knows or has reason to know that such transactions are part of a financing arrangement. In addition, the proposed regulations require a financed entity or any other person to keep records relevant to determining whether such person is a party to a financing arrangement that is subject to recharacterization as part of their general recordkeeping requirements under section 6001.

Commentators criticized the reporting requirements imposed by the proposed regulation as unduly burdensome in that they would require reporting of all financing arrangements and not simply those subject to recharacterization as conduit financing arrangements. Moreover, they pointed out that, because the regulations only would require reporting of those transactions to which the financed entity is a party, the information reported would not be of significant value. The reported information would not be sufficient to allow the IRS to connect the reported financing transaction to the other financing transactions making up a financing arrangement.

The final regulations eliminate the reporting requirements provided in the proposed regulations and provide more specific guidance as to the type of records affected entities must retain. The recordkeeping requirements of § 1.881–4 have been revised to incorporate all of the information that entities would have had to report under the proposed regulations. In addition, the final regulations require the entity to retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrangements, including minutes of board of directors meetings and board resolutions and materials from investment advisors regarding the structuring of the transaction. See § 1.881–4(c)(2).

11. Withholding Obligations

Under the proposed regulations, a person that is otherwise a withholding agent is required to withhold tax under section 1441 or section 1442 in accordance with the recharacterization of a financing arrangement if the person knows or has reason to know that the financing arrangement is subject to recharacterization under sections 871 or 881. Commentators asked for additional guidance regarding the application of the ''know or have reason to know'' standard in the context of conduit financing arrangements. The final regulations include several examples regarding the circumstances in which a financed entity does and does not have

reason to know of the existence of a conduit financing arrangement.

C. Status of Revenue Rulings

The proposed regulations did not address the status of the existing revenue rulings relating to conduit arrangements. Commentators have asked for guidance regarding their status.

Concurrent with the publication of these regulations, the IRS is issuing a revenue ruling modifying the existing rulings. The revenue ruling limits the application of the old revenue rulings in the context of withholding tax to payments made before the effective date of the final regulations and to other provisions not covered by the conduit regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the information that follows. These regulations affect entities engaged in cross-border multiple-party financing arrangements. It is assumed that a substantial number of small entities will not engage in such financing arrangements. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small businesses.

Drafting Information: The principal author of these regulations is Elissa J. Shendalman, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for ''Sections 1.6038A–1 through 1.6038A–7'' and adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.871–1 also issued under 26 U.S.C. 7701(l). * * *
Section 1.881–3 also issued under 26 U.S.C. 7701(l).
Section 1.881–4 also issued under 26 U.S.C. 7701(l). * * *
Section 1.1441–3 also issued under 26 U.S.C. 7701(l). * * *
Section 1.1441–7 also issued under 26 U.S.C. 7701(l). * * *
Section 1.6038A–1 also issued under 26 U.S.C. 6038A.
Section 1.6038A–2 also issued under 26 U.S.C. 6038A.
Section 1.6038A–3 also issued under 26 U.S.C. 6038A and 7701(l).
Section 1.6038A–4 also issued under 26 U.S.C. 6038A.
Section 1.6038A–5 also issued under 26 U.S.C. 6038A.
Section 1.6038A–6 also issued under 26 U.S.C. 6038A.
Section 1.6038A–7 also issued under 26 U.S.C. 6038A. * * *
Section 1.7701(l)–1 also issued under 26 U.S.C. 7701(l). * * *

Par. 2. In § 1.871–1, paragraph (b)(7) is added to read as follows:

§ 1.871–1 Classification and manner of taxing alien individuals.

* * * * *

(b) * * *

(7) *Conduit financing arrangements.* For rules regarding conduit financing arrangements, see §§ 1.881–3 and 1.881–4.

* * * * *

Par. 3. Sections 1.881–0, 1.881–3 and 1.881–4 are added to read as follows:

§ 1.881–0 Table of contents.

This section lists the major headings for §§ 1.881–1 through 1.881–4.

§ 1.881–1 Manner of Taxing Foreign Corporations

(a) Classes of foreign corporations.
(b) Manner of taxing.
(1) Foreign corporations not engaged in U.S. business.
(2) Foreign corporations engaged in U.S. business.
(c) Meaning of terms.
(d) Rules applicable to foreign insurance companies.
(1) Corporations qualifying under subchapter L.
(2) Corporations not qualifying under subchapter L.
(e) Other provisions applicable to foreign corporations.
(1) Accumulated earnings tax.
(2) Personal holding company tax.
(3) Foreign personal holding companies.
(4) Controlled foreign corporations.
(i) Subpart F income and increase of earnings invested in U.S. property.
(ii) Certain accumulations of earnings and profits.
(5) Changes in tax rate.
(6) Consolidated returns.
(7) Adjustment of tax of certain foreign corporations.
(f) Effective date.

§ 1.881–2 Taxation of Foreign Corporations Not Engaged in U.S. Business

(a) Imposition of tax.
(b) Fixed or determinable annual or periodical income.
(c) Other income and gains.
(1) Items subject to tax.
(2) Determination of amount of gain.
(d) Credits against tax.
(e) Effective date.

§ 1.881–3 Conduit Financing Arrangements

(a) General rules and definitions.
(1) Purpose and scope.
(2) Definitions.
(i) Financing arrangement.
(A) In general.
(B) Special rule for related parties.
(ii) Financing transaction.
(A) In general.
(B) Limitation on inclusion of stock or similar interests.
(iii) Conduit entity.
(iv) Conduit financing arrangement.
(v) Related.
(3) Disregard of participation of conduit entity.
(i) Authority of district director.
(ii) Effect of disregarding conduit entity.
(A) In general.
(B) Character of payments made by the financed entity.
(C) Effect of income tax treaties.
(D) Effect on withholding tax.
(E) Special rule for a financing entity that is unrelated to both intermediate entity and financed entity.
(iii) Limitation on taxpayers's use of this section.
(4) Standard for treatment as a conduit entity.
(i) In general.
(ii) Multiple intermediate entities.
(A) In general.
(B) Special rule for related persons.
(b) Determination of whether participation of intermediate entity is pursuant to a tax avoidance plan.
(1) In general.
(2) Factors taken into account in determining the presence or absence of a tax avoidance purpose.
(i) Significant reduction in tax.
(ii) Ability to make the advance.
(iii) Time period between financing transactions.
(iv) Financing transactions in the ordinary course of business.
(3) Presumption if significant financing activities performed by a related intermediate entity.
(i) General rule.
(ii) Significant financing activities.
(A) Active rents or royalties.
(B) Active risk management.
(c) Determination of whether an unrelated intermediate entity would not have participated in financing arrangement on substantially same terms.
(1) In general.

(2) Effect of guarantee.
(i) In general.
(ii) Definition of guarantee.
(d) Determination of amount of tax liability.
(1) Amount of payment subject to recharacterization.
(i) In general.
(ii) Determination of principal amount.
(A) In general.
(B) Debt instruments and certain stock.
(C) Partnership and trust interests.
(D) Leases and licenses.
(2) Rate of tax.
(e) Examples.
(f) Effective date.

§ 1.881–4 Recordkeeping Requirements Concerning Conduit Financing Arrangements

(a) Scope.
(b) Recordkeeping requirements.
(1) In general.
(2) Application of sections 6038 and 6038A.
(c) Records to be maintained.
(1) In general.
(2) Additional documents.
(3) Effect of record maintenance requirement.
(d) Effective date.

§ 1.881–3 Conduit financing arrangements.

(a) *General rules and definitions*—(1) *Purpose and scope.* Pursuant to the authority of section 7701(l), this section provides rules that permit the district director to disregard, for purposes of section 881, the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities. For purposes of this section, any reference to tax imposed under section 881 includes, except as otherwise provided and as the context may require, a reference to tax imposed under sections 871 or 884(f)(1)(A) or required to be withheld under section 1441 or 1442. See § 1.881–4 for recordkeeping requirements concerning financing arrangements. See §§ 1.1441–3(j) and 1.1441–7(d) for withholding rules applicable to conduit financing arrangements.

(2) *Definitions.* The following definitions apply for purposes of this section and §§ 1.881–4, 1.1441–3(j) and 1.1441–7(d).

(i) *Financing arrangement*—(A) *In general.* Financing arrangement means a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and, except in cases to which paragraph (a)(2)(i)(B) of this section applies, there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity. A transfer of money or other property in satisfaction of a repayment obligation is not an advance of money or other property. A financing arrangement exists regardless of the order in which the transactions are entered into, but only for the period during which all of the financing transactions coexist. See *Examples 1*, *2*, and *3* of paragraph (e) of this section for illustrations of the term financing arrangement.

(B) *Special rule for related parties.* If two (or more) financing transactions involving two (or more) related persons would form part of a financing arrangement but for the absence of a financing transaction between the related persons, the district director may treat the related persons as a single intermediate entity if he determines that one of the principal purposes for the structure of the financing transactions is to prevent the characterization of such arrangement as a financing arrangement. This determination shall be based upon all of the facts and circumstances, including, without limitation, the factors set forth in paragraph (b)(2) of this section. See *Examples 4* and *5* of paragraph (e) of this section for illustrations of this paragraph (a)(2)(i)(B).

(ii) *Financing transaction*—(A) *In general.* Financing transaction means—

(*1*) Debt;

(*2*) Stock in a corporation (or a similar interest in a partnership or trust) that meets the requirements of paragraph (a)(2)(ii)(B) of this section;

(*3*) Any lease or license; or

(*4*) Any other transaction (including an interest in a trust described in sections 671 through 679) pursuant to which a person makes an advance of money or other property or grants rights to use property to a transferee who is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value. This paragraph (a)(2)(ii)(A)(*4*) shall not apply to the posting of collateral unless the collateral consists of cash or the person holding the collateral is permitted to reduce the collateral to cash (through a transfer, grant of a security interest or similar transaction) prior to default on the financing transaction secured by the collateral.

(B) *Limitation on inclusion of stock or similar interests*—(*1*) *In general.* Stock in a corporation (or a similar interest in a partnership or trust) will constitute a financing transaction only if one of the following conditions is satisfied—

(*i*) The issuer is required to redeem the stock or similar interest at a specified time or the holder has the right to require the issuer to redeem the stock or similar interest or to make any other payment with respect to the stock or similar interest;

(*ii*) The issuer has the right to redeem the stock or similar interest, but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur; or

(*iii*) The owner of the stock or similar interest has the right to require a person related to the issuer (or any other person who is acting pursuant to a plan or arrangement with the issuer) to acquire the stock or similar interest or make a payment with respect to the stock or similar interest.

(*2*) *Rules of special application*—(*i*) *Existence of a right.* For purposes of this paragraph (a)(2)(ii)(B), a person will be considered to have a right to cause a redemption or payment if the person has the right (other than rights arising, in the ordinary course, between the date that a payment is declared and the date that a payment is made) to enforce the payment through a legal proceeding or to cause the issuer to be liquidated if it fails to redeem the interest or to make a payment. A person will not be considered to have a right to force a redemption or a payment if the right is derived solely from ownership of a controlling interest in the issuer in cases where the control does not arise from a default or similar contingency under the instrument. The person is considered to have such a right if the person has the right as of the issue date or, as of the issue date, it is more likely than not that the person will receive such a right, whether through the occurrence of a contingency or otherwise.

(*ii*) *Restrictions on payment.* The fact that the issuer does not have the legally available funds to redeem the stock or similar interest, or that the payments are to be made in a blocked currency, will not affect the determinations made pursuant to this paragraph (a)(2)(ii)(B).

(*iii*) *Conduit entity* means an intermediate entity whose participation in the financing arrangement may be disregarded in whole or in part pursuant to this section, whether or not the district director has made a determination that the intermediate entity should be disregarded under paragraph (a)(3)(i) of this section.

(*iv*) *Conduit financing arrangement* means a financing arrangement that is effected through one or more conduit entities.

(*v*) *Related* means related within the meaning of sections 267(b) or 707(b)(1), or controlled within the meaning of section 482, and the regulations under those sections. For purposes of

determining whether a person is related to another person, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(*3*) *Disregard of participation of conduit entity*—(i) *Authority of district director.* The district director may determine that the participation of a conduit entity in a conduit financing arrangement should be disregarded for purposes of section 881. For this purpose, an intermediate entity will constitute a conduit entity if it meets the standards of paragraph (a)(4) of this section. The district director has discretion to determine the manner in which the standards of paragraph (a)(4) of this section apply, including the financing transactions and parties composing the financing arrangement.

(ii) *Effect of disregarding conduit entity*—(A) *In general.* If the district director determines that the participation of a conduit entity in a financing arrangement should be disregarded, the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement (in most cases, the financed entity and the financing entity) for purposes of section 881. To the extent that a disregarded conduit entity actually receives or makes payments pursuant to a conduit financing arrangement, it is treated as an agent of the financing entity. Except as otherwise provided, the recharacterization of the conduit financing arrangement also applies for purposes of sections 871, 884(f)(1)(A), 1441, and 1442 and other procedural provisions relating to those sections. This recharacterization will not otherwise affect a taxpayer's Federal income tax liability under any substantive provisions of the Internal Revenue Code. Thus, for example, the recharacterization generally applies for purposes of section 1461, in order to impose liability on a withholding agent who fails to withhold as required under § 1.1441–3(j), but not for purposes of § 1.882–5.

(B) *Character of payments made by the financed entity.* If the participation of a conduit financing arrangement is disregarded under this paragraph (a)(3), payments made by the financed entity generally shall be characterized by reference to the character (e.g., interest or rent) of the payments made to the financing entity. However, if the financing transaction to which the financing entity is a party is a transaction described in paragraph (a)(2)(ii)(A)(*2*) or (*4*) of this section that gives rise to payments that would not be deductible if paid by the financed entity, the character of the payments made by the financed entity will not be affected by the disregard of the participation of a conduit entity. The characterization provided by this paragraph (a)(3)(ii)(B) does not, however, extend to qualification of a payment for any exemption from withholding tax under the Internal Revenue Code or a provision of any applicable tax treaty if such qualification depends on the terms of, or other similar facts or circumstances relating to, the financing transaction to which the financing entity is a party that do not apply to the financing transaction to which the financed entity is a party. Thus, for example, payments made by a financed entity that is not a bank cannot qualify for the exemption provided by section 881(i) of the Code even if the loan between the financed entity and the conduit entity is a bank deposit.

(C) *Effect of income tax treaties.* Where the participation of a conduit entity in a conduit financing arrangement is disregarded pursuant to this section, it is disregarded for all purposes of section 881, including for purposes of applying any relevant income tax treaties. Accordingly, the conduit entity may not claim the benefits of a tax treaty between its country of residence and the United States to reduce the amount of tax due under section 881 with respect to payments made pursuant to the conduit financing arrangement. The financing entity may, however, claim the benefits of any income tax treaty under which it is entitled to benefits in order to reduce the rate of tax on payments made pursuant to the conduit financing arrangement that are recharacterized in accordance with paragraph (a)(3)(ii)(B) of this section.

(D) *Effect on withholding tax.* For the effect of recharacterization on withholding obligations, see §§ 1.1441–3(j) and 1.1441–7(d).

(E) *Special rule for a financing entity that is unrelated to both intermediate entity and financed entity—(1) Liability of financing entity.* Notwithstanding the fact that a financing arrangement is a conduit financing arrangement, a financing entity that is unrelated to the financed entity and the conduit entity (or entities) shall not itself be liable for tax under section 881 unless the financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement. But see § 1.1441–3(j) for the withholding agent's withholding obligations.

(*2*) *Financing entity's knowledge*—(*i*) *In general.* A financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement only if the financing entity knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A person that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

(*ii*) *Presumption regarding financing entity's knowledge.* It shall be presumed that the financing entity does not know or have reason to know that the financing arrangement is a conduit financing arrangement if the financing entity is unrelated to all other parties to the financing arrangement and the financing entity establishes that the intermediate entity who is a party to the financing transaction with the financing entity is actively engaged in a substantial trade or business. An intermediate entity will not be considered to be engaged in a trade or business if its business is making or managing investments, unless the intermediate entity is actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. An intermediate entity's trade or business is substantial if it is reasonable for the financing entity to expect that the intermediate entity will be able to make payments under the financing transaction out of the cash flow of that trade or business. This presumption may be rebutted if the district director establishes that the financing entity knew or had reason to know that the financing arrangement is a conduit financing arrangement. See *Example 6* of paragraph (e) of this section for an illustration of the rules of this paragraph (a)(3)(ii)(E).

(iii) *Limitation on taxpayer's use of this section.* A taxpayer may not apply this section to reduce the amount of its Federal income tax liability by disregarding the form of its financing transactions for Federal income tax purposes or by compelling the district director to do so. See, however, paragraph (b)(2)(i) of this section for rules regarding the taxpayer's ability to show that the participation of one or more intermediate entities results in no significant reduction in tax.

(4) *Standard for treatment as a conduit entity*—(i) *In general.* An intermediate entity is a conduit entity with respect to a financing arrangement if—

(A) The participation of the intermediate entity (or entities) in the financing arrangement reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would have been imposed under paragraph (d) of this section);

(B) The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and

(C) Either—

(*1*) The intermediate entity is related to the financing entity or the financed entity; or

(*2*) The intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

(ii) *Multiple intermediate entities*—(A) *In general.* If a financing arrangement involves multiple intermediate entities, the district director will determine whether each of the intermediate entities is a conduit entity. The district director will make the determination by applying the special rules for multiple intermediate entities provided in this section or, if no special rules are provided, applying principles consistent with those of paragraph (a)(4)(i) of this section to each of the intermediate entities in the financing arrangement.

(B) *Special rule for related persons.* The district director may treat related intermediate entities as a single intermediate entity if he determines that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent the provisions of this section. This determination shall be based upon all of the facts and circumstances, including, but not limited to, the factors set forth in paragraph (b)(2) of this section. If a district director determines that related persons are to be treated as a single intermediate entity, financing transactions between such related parties that are part of the conduit financing arrangement shall be disregarded for purposes of applying this section. *See Examples 7* and *8* of paragraph (e) of this section for illustrations of the rules of this paragraph (a)(4)(ii).

(b) *Determination of whether participation of intermediate entity is pursuant to a tax avoidance plan*—(1) *In general.* A tax avoidance plan is a plan one of the principal purposes of which is the avoidance of tax imposed by section 881. Avoidance of the tax imposed by section 881 may be one of the principal purposes for such a plan even though it is outweighed by other purposes (taken together or separately). In this regard, the only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement and not those pertaining to the existence of a financing arrangement as a whole. The plan may be formal or informal, written or oral, and may involve any one or more of the parties to the financing arrangement. The plan must be in existence no later than the last date that any of the financing transactions comprising the financing arrangement is entered into. The district director may infer the existence of a tax avoidance plan from the facts and circumstances. In determining whether there is a tax avoidance plan, the district director will weigh all relevant evidence regarding the purposes for the intermediate entity's participation in the financing arrangement. See *Examples 11* and *12* of paragraph (e) of this section for illustrations of the rule of this paragraph (b)(1).

(2) *Factors taken into account in determining the presence or absence of a tax avoidance purpose.* The factors described in paragraphs (b)(2)(i) through (iv) of this section are among the facts and circumstances taken into account in determining whether the participation of an intermediate entity in a financing arrangement has as one of its principal purposes the avoidance of tax imposed by section 881.

(i) *Significant reduction in tax.* The district director will consider whether the participation of the intermediate entity (or entities) in the financing arrangement significantly reduces the tax that otherwise would have been imposed under section 881. The fact that an intermediate entity is a resident of a country that has an income tax treaty with the United States that significantly reduces the tax that otherwise would have been imposed under section 881 is not sufficient, by itself, to establish the existence of a tax avoidance plan. The determination of whether the participation of an intermediate entity significantly reduces the tax generally is made by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would be imposed under paragraph (d) of this section. However, the taxpayer is not barred from presenting evidence that the financing entity, as determined by the district director, was itself an intermediate entity and another entity should be treated as the financing entity for purposes of applying this test. A reduction in the absolute amount of tax may be significant even if the reduction in rate is not. A reduction in the amount of tax may be significant if the reduction is large in absolute terms or in relative terms. See *Examples 13, 14* and *15* of paragraph (e) of this section for illustrations of this factor.

(ii) *Ability to make the advance.* The district director will consider whether the intermediate entity had sufficient available money or other property of its own to have made the advance to the financed entity without the advance of money or other property to it by the financing entity (or in the case of multiple intermediate entities, whether each of the intermediate entities had sufficient available money or other property of its own to have made the advance to either the financed entity or another intermediate entity without the advance of money or other property to it by either the financing entity or another intermediate entity).

(iii) *Time period between financing transactions.* The district director will consider the length of the period of time that separates the advances of money or other property, or the grants of rights to use property, by the financing entity to the intermediate entity (in the case of multiple intermediate entities, from one intermediate entity to another), and ultimately by the intermediate entity to the financed entity. A short period of time is evidence of the existence of a tax avoidance plan while a long period of time is evidence that there is not a tax avoidance plan. See *Example 16* of paragraph (e) of this section for an illustration of this factor.

(iv) *Financing transactions in the ordinary course of business.* If the parties to the financing transaction are related, the district director will consider whether the financing transaction occurs in the ordinary course of the active conduct of complementary or integrated trades or businesses engaged in by these entities. The fact that a financing transaction is described in this paragraph (b)(2)(iv) is evidence that the participation of the parties to that transaction in the financing arrangement is not pursuant to a tax avoidance plan. A loan will not be considered to occur in the ordinary

course of the active conduct of complementary or integrated trades or businesses unless the loan is a trade receivable or the parties to the transaction are actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. See *Example 17* of paragraph (e) of this section for an illustration of this factor.

(3) *Presumption if significant financing activities performed by a related intermediate entity*—(i) *General rule*. It shall be presumed that the participation of an intermediate entity (or entities) in a financing arrangement is not pursuant to a tax avoidance plan if the intermediate entity is related to either or both the financing entity or the financed entity and the intermediate entity performs significant financing activities with respect to the financing transactions forming part of the financing arrangement to which it is a party. This presumption may be rebutted if the district director establishes that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. See *Examples 21*, *22* and *23* of paragraph (e) of this section for illustrations of this presumption.

(ii) *Significant financing activities*. For purposes of this paragraph (b)(3), an intermediate entity performs significant financing activities with respect to such financing transactions only if the financing transactions satisfy the requirements of either paragraph (b)(3)(ii)(A) or (B) of this section.

(A) *Active rents or royalties*. An intermediate entity performs significant financing activities with respect to leases or licenses if rents or royalties earned with respect to such leases or licenses are derived in the active conduct of a trade or business within the meaning of section 954(c)(2)(A), to be applied by substituting the term *intermediate* entity for the term *controlled foreign corporation*.

(B) *Active risk management*—(*1*) *In general*. An intermediate entity is considered to perform significant financing activities with respect to financing transactions only if officers and employees of the intermediate entity participate actively and materially in arranging the intermediate entity's participation in such financing transactions (other than financing transactions described in paragraph (b)(3)(ii)(*B*)(*3*) of this section) and perform the business activity and risk management activities described in paragraph (b)(3)(ii)(*B*)(*2*) of this section with respect to such financing transactions, and the participation of the intermediate entity in the financing transactions produces (or reasonably can be expected to produce) efficiency savings by reducing transaction costs and overhead and other fixed costs.

(*2*) *Business activity and risk management requirements*. An intermediate entity will be considered to perform significant financing activities only if, within the country in which the intermediate entity is organized (or, if different, within the country with respect to which the intermediate entity is claiming the benefits of a tax treaty), its officers and employees—

(*i*) Exercise management over, and actively conduct, the day-to-day operations of the intermediate entity. Such operations must consist of a substantial trade or business or the supervision, administration and financing for a substantial group of related persons; and

(*ii*) Actively manage, on an ongoing basis, material market risks arising from such financing transactions as an integral part of the management of the intermediate entity's financial and capital requirements (including management of risks of currency and interest rate fluctuations) and management of the intermediate entity's short-term investments of working capital by entering into transactions with unrelated persons.

(*3*) *Special rule for trade receivables and payables entered into in the ordinary course of business*. If the activities of the intermediate entity consist in whole or in part of cash management for a controlled group of which the intermediate entity is a member, then employees of the intermediate entity need not have participated in arranging any such financing transactions that arise in the ordinary course of a substantial trade or business of either the financed entity or the financing entity. Officers or employees of the financing entity or financed entity, however, must have participated actively and materially in arranging the transaction that gave rise to the trade receivable or trade payable. Cash management includes the operation of a sweep account whereby the intermediate entity nets intercompany trade payables and receivables arising from transactions among the other members of the controlled group and between members of the controlled group and unrelated persons.

(*4*) *Activities of officers and employees of related persons*. Except as provided in paragraph (b)(3)(ii)(B)(*3*) of this section, in applying this paragraph (b)(3)(ii)(B), the activities of an officer or employee of an intermediate entity will not constitute significant financing activities if any officer or employee of a related person participated materially in any of the activities described in this paragraph, other than to approve any guarantee of a financing transaction or to exercise general supervision and control over the policies of the intermediate entity.

(c) *Determination of whether an unrelated intermediate entity would not have participated in financing arrangement on substantially the same terms*—(1) *In general*. The determination of whether an intermediate entity would not have participated in a financing arrangement on substantially the same terms but for the financing transaction between the financing entity and the intermediate entity shall be based upon all of the facts and circumstances.

(2) *Effect of guarantee*—(i) *In general*. The district director may presume that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if there is a guarantee of the financed entity's liability to the intermediate entity (or in the case of multiple intermediate entities, a guarantee of the intermediate entity's liability to the intermediate entity that advanced money or property, or granted rights to use other property). However, a guarantee that was neither in existence nor contemplated on the last date that any of the financing transactions comprising the financing arrangement is entered into does not give rise to this presumption. A taxpayer may rebut this presumption by producing clear and convincing evidence that the intermediate entity would have participated in the financing transaction with the financed entity on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity.

(ii) *Definition of guarantee*. For the purposes of this paragraph (c)(2), a guarantee is any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another person's obligation with respect to a financing transaction. The term shall be interpreted in accordance with the definition of the term in section 163(j)(6)(D)(iii).

(d) *Determination of amount of tax liability*—(1) *Amount of payment subject to recharacterization*—(i) *In general*. If a financing arrangement is a conduit financing arrangement, a portion of each payment made by the financed entity with respect to the

financing transactions that comprise the conduit financing arrangement shall be recharacterized as a transaction directly between the financed entity and the financing entity. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, the entire amount of the payment shall be so recharacterized. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is greater than the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, then the recharacterized portion shall be determined by multiplying the payment by a fraction the numerator of which is equal to the lowest aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement (other than financing transactions that are disregarded pursuant to paragraphs (a)(2)(i)(B) and (a)(4)(ii)(B) of this section) and the denominator of which is the aggregate principal amount of the financing transaction(s) to which the financed entity is a party. In the case of financing transactions the principal amount of which is subject to adjustment, the fraction shall be determined using the average outstanding principal amounts for the period to which the payment relates. The average principal amount may be computed using any method applied consistently that reflects with reasonable accuracy the amount outstanding for the period. See *Example 24* of paragraph (e) of this section for an illustration of the calculation of the amount of tax liability.

(ii) *Determination of principal amount*—(A) *In general.* Unless otherwise provided in this paragraph (d)(1)(ii), the principal amount equals the amount of money advanced, or the fair market value of other property advanced or subject to a lease or license, in the financing transaction. In general, fair market value is calculated in U.S. dollars as of the close of business on the day on which the financing transaction is entered into. However, if the property advanced, or the right to use property granted, by the financing entity is the same as the property or rights received by the financed entity, the fair market value of the property or right shall be determined as of the close of business on the last date that any of the financing transactions comprising the financing arrangement is entered into. In the case of fungible property, property of the same type shall be considered to be the same property. See *Example 25* of paragraph (e) for an illustration of the calculation of the principal amount in the case of financing transactions involving fungible property. The principal amount of a financing transaction shall be subject to adjustments, as set forth in this paragraph (d)(1)(ii).

(B) *Debt instruments and certain stock.* In the case of a debt instrument or of stock that is subject to the current inclusion rules of sections 305(c)(3) or (e), the principal amount generally will be equal to the issue price. However, if the fair market value on the issue date differs materially from the issue price, the fair market value of the debt instrument shall be used in lieu of the instrument's issue price. Appropriate adjustments will be made for accruals of original issue discount and repayments of principal (including accrued original issue discount).

(C) *Partnership and trust interests.* In the case of a partnership interest or an interest in a trust, the principal amount is equal to the fair market value of the money or property contributed to the partnership or trust in return for that partnership or trust interest.

(D) *Leases or licenses.* In the case of a lease or license, the principal amount is equal to the fair market value of the property subject to the lease or license on the date on which the lease or license is entered into. The principal amount shall be adjusted for depreciation or amortization, calculated on a basis that accurately reflects the anticipated decline in the value of the property over its life.

(2) *Rate of tax.* The rate at which tax is imposed under section 881 on the portion of the payment that is recharacterized pursuant to paragraph (d)(1) of this section is determined by reference to the nature of the recharacterized transaction, as determined under paragraphs (a)(3)(ii)(B) and (C) of this section.

(e) *Examples.* The following examples illustrate this section. For purposes of these examples, unless otherwise indicated, it is assumed that FP, a corporation organized in country N, owns all of the stock of FS, a corporation organized in country T, and DS, a corporation organized in the United States. Country T, but not country N, has an income tax treaty with the United States. The treaty exempts interest, rents and royalties paid by a resident of one state (the source state) to a resident of the other state from tax in the source state.

Example 1. Financing arrangement. (i) On January 1, 1996, BK, a bank organized in country T, lends $1,000,000 to DS in exchange for a note issued by DS. FP guarantees to BK that DS will satisfy its repayment obligation on the loan. There are no other transactions between FP and BK.

(ii) BK's loan to DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section. FP's guarantee of DS's repayment obligation is not a financing transaction as described in paragraphs (a)(2)(ii)(A)(*1*) through (*4*) of this section. Therefore, these transactions do not constitute a financing arrangement as defined in paragraph (a)(2)(i) of this section.

Example 2. Financing arrangement. (i) On January 1, 1996, FP lends $1,000,000 to DS in exchange for a note issued by DS. On January 1, 1997, FP assigns the DS note to FS in exchange for a note issued by FS. After receiving notice of the assignment, DS remits payments due under its note to FS.

(ii) The DS note held by FS and the FS note held by FP are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 3. Financing arrangement. (i) On December 1, 1994 FP creates a special purposes subsidiary, FS. On that date FP capitalizes FS with $1,000,000 in cash and $10,000,000 in debt from BK, a Country N bank. On January 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On August 1, 1995, DS sells a number of installment notes, including C's, to FS in exchange for $10,000,000. DS continues to service the installment notes for FS.

(ii) The C installment note now held by FS (as well as all of the other installment notes now held by FS) and the FS note held by BK are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 4. Related persons treated as a single intermediate entity. (i) On January 1, 1996, FP deposits $1,000,000 with BK, a bank that is organized in country N and is unrelated to FP and its subsidiaries. M, a corporation also organized in country N, is wholly-owned by the sole shareholder of BK but is not a bank within the meaning of section 881(c)(3)(A). On July 1, 1996, M lends $1,000,000 to DS in exchange for a note maturing on July 1, 2006. The note is in registered form within the meaning of section 881(c)(2)(B)(i) and DS has received from M the statement required by section 881(c)(2)(B)(ii). One of the principal purposes for the absence of a financing transaction between BK and M is the avoidance of the application of this section.

(ii) The transactions described above would form a financing arrangement but for the absence of a financing transaction between BK and M. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of such arrangement as a financing arrangement, the district director may treat the financing transactions between

FP and BK, and between M and DS as a financing arrangement under paragraphs (a)(2)(i)(B) of this section. In such a case, BK and M would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(4)(ii)(B) of this section for the authority to treat BK and M as a single intermediate entity.

Example 5. Related persons treated as a single intermediate entity. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes $10,000,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock of FS2. On January 1, 1996, FS2 lends $10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company whose most significant asset is the stock of FS2. Throughout the period that the FP–FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP–FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP–FS loan. One of the principal purposes for the absence of a financing transaction between FS and FS2 is the avoidance of the application of this section.

(ii) The conditions of paragraph (a)(4)(i)(A) of this section would be satisfied with respect to the financing transactions between FP, FS, FS2 and DS but for the absence of a financing transaction between FS and FS2. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of an entity as a conduit, the district director may treat the financing transactions between FP and FS, and between FS2 and DS as a financing arrangement. See paragraph (a)(4)(ii)(B) of this section. In such a case, FS and FS2 would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(2)(i)(B) of this section for the authority to treat FS and FS2 as a single intermediate entity.

Example 6. Presumption with respect to unrelated financing entity. (i) FP is a corporation organized in country T that is actively engaged in a substantial manufacturing business. FP has a revolving credit facility with a syndicate of banks, none of which is related to FP and FP's subsidiaries, which provides that FP may borrow up to a maximum of $100,000,000 at a time. The revolving credit facility provides that DS and certain other subsidiaries of FP may borrow directly from the syndicate at the same interest rates as FP, but each subsidiary is required to indemnify the syndicate banks for any withholding taxes imposed on interest payments by the country in which the subsidiary is organized. BK, a bank that is organized in country N, is the agent for the syndicate. Some of the syndicate banks are organized in country N, but others are residents of country O, a country that has an income tax treaty with the United States which allows the United States to impose a tax on interest at a maximum rate of 10 percent. It is reasonable for BK and the syndicate banks to have determined that FP will be able to meet its payment obligations on a maximum principal amount of $100,000,000 out of the cash flow of its manufacturing business. At various times throughout 1995, FP borrows under the revolving credit facility until the outstanding principal amount reaches the maximum amount of $100,000,000. On December 31, 1995, FP receives $100,000,000 from a public offering of its equity. On January 1, 1996, FP pays BK $90,000,000 to reduce the outstanding principal amount under the revolving credit facility and lends $10,000,000 to DS. FP would have repaid the entire principal amount, and DS would have borrowed directly from the syndicate, but for the fact that DS did not want to incur the U.S. withholding tax that would have applied to payments made directly by DS to the syndicate banks.

(ii) Pursuant to paragraph (a)(3)(ii)(E)(*1*) of this section, even though the financing arrangement is a conduit financing arrangement (because the financing arrangement meets the standards for recharacterization in paragraph (a)(4)(i)), BK and the other syndicate banks have no section 881 liability unless they know or have reason to know that the financing arrangement is a conduit financing arrangement. Moreover, pursuant to paragraph (a)(3)(ii)(E)(*2*)(*ii*) of this section, BK and the syndicate banks are presumed not to know that the financing arrangement is a conduit financing arrangement. The syndicate banks are unrelated to both FP and DS, and FP is actively engaged in a substantial trade or business—that is, the cash flow from FP's manufacturing business is sufficient for the banks to expect that FP will be able to make the payments required under the financing transaction. See § 1.1441–3(j) for the withholding obligations of the withholding agents.

Example 7. Multiple intermediate entities—special rule for related persons. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes $9,900,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock and lends $100,000 to FS2. On January 1, 1996, FS2 lends $10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company that has no significant assets other than the stock of FS2. Throughout the period that the FP–FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP–FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP–FS loan. One of the principal purposes for structuring the transactions between FS and FS2 as primarily a contribution of capital is to reduce the amount of the payment that would be recharacterized under paragraph (d) of this section.

(ii) Pursuant to paragraph (a)(4)(ii)(B) of this section, the district director may treat FS and FS2 as a single intermediate entity for purposes of this section since one of the principal purposes for the participation of multiple intermediate entities is to reduce the amount of the tax liability on any recharacterized payment by inserting a financing transaction with a low principal amount.

Example 8. Multiple intermediate entities. (i) On January 1, 1995, FP deposits $1,000,000 with BK, a bank that is organized in country T and is unrelated to FP and its subsidiaries, FS and DS. On January 1, 1996, at a time when the FP–BK deposit is still outstanding, BK lends $500,000 to BK2, a bank that is wholly-owned by BK and is organized in country T. On the same date, BK2 lends $500,000 to FS. On July 1, 1996, FS lends $500,000 to DS. FP pledges its deposit with BK to BK2 in support of FS' obligation to repay the BK2 loan. FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan.

(ii) The conditions of paragraphs (a)(4)(i)(A) and (B) of this section are satisfied because the participation of BK, BK2 and FS in the financing arrangement reduces the tax imposed by section 881, and FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan. However, since BK and BK2 are unrelated to FP and DS, under paragraph (a)(4)(i)(C)(*2*) of this section, BK and BK2 will be treated as conduit entities only if BK and BK2 would not have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK.

(iii) It is presumed that BK2 would not have participated in the financing arrangement on substantially the same terms but for the BK–BK2 financing transaction because FP's pledge of an asset in support of FS' obligation to repay the BK2 loan is a guarantee within the meaning of paragraph (c)(2)(ii) of this section. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK2 will be a conduit entity.

(iv) Because BK and BK2 are related intermediate entities, the district director must determine whether one of the principal purposes for the involvement of multiple intermediate entities was to prevent characterization of an entity as a conduit entity. In making this determination, the district director may consider the fact that the involvement of two related intermediate entities prevents the presumption regarding guarantees from applying to BK. In the absence of evidence showing a business purpose for the involvement of both BK and BK2, the district director may treat BK and BK2 as a single intermediate entity for purposes of determining whether they would have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK. The presumption that applies to BK2 therefore will apply to BK. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK will be a conduit entity.

Example 9. Reduction of tax. (i) On February 1, 1995, FP issues debt to the public

that would satisfy the requirements of section 871(h)(2)(A) (relating to obligations that are not in registered form) if issued by a U.S. person. FP lends the proceeds of the debt offering to DS in exchange for a note.

(ii) The debt issued by FP and the DS note are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The holders of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Because interest payments on the debt issued by FP would not have been subject to withholding tax if the debt had been issued by DS, there is no reduction in tax under paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 10. Reduction of tax. (i) On January 1, 1995, FP licenses to FS the rights to use a patent in the United States to manufacture product A. FS agrees to pay FP a fixed amount in royalties each year under the license. On January 1, 1996, FS sublicenses to DS the rights to use the patent in the United States. Under the sublicense, DS agrees to pay FS royalties based upon the units of product A manufactured by DS each year. Although the formula for computing the amount of royalties paid by DS to FS differs from the formula for computing the amount of royalties paid by FS to FP, each represents an arm's length rate.

(ii) Although the royalties paid by DS to FS are exempt from U.S. withholding tax, the royalty payments between FS and FP are income from U.S. sources under section 861(a)(4) subject to the 30 percent gross tax imposed by § 1.881–2(b) and subject to withholding under § 1.1441–2(a). Because the rate of tax imposed on royalties paid by FS to FP is the same as the rate that would have been imposed on royalties paid by DS to FP, the participation of FS in the FP–FS–DS financing arrangement does not reduce the tax imposed by section 881 within the meaning of paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 11. A principal purpose. (i) On January 1, 1995, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. As was intended at the time of the loan from FS to DS, on July 1, 1995, FP makes an interest-free demand loan of $10,000,000 to FS. A principal purpose for FS' participation in the FP–FS–DS financing arrangement is that FS generally coordinates the financing for all of FP's subsidiaries (although FS does not engage in significant financing activities with respect to such financing transactions). However, another principal purpose for FS' participation is to allow the parties to benefit from the lower withholding tax rate provided under the income tax treaty between country T and the United States.

(ii) The financing arrangement satisfies the tax avoidance purpose requirement of paragraph (a)(4)(i)(B) of this section because FS participated in the financing arrangement pursuant to a plan one of the principal purposes of which is to allow the parties to benefit from the country T-U.S. treaty.

Example 12. A principal purpose. (i) DX is a U.S. corporation that intends to purchase property to use in its manufacturing business. FX is a partnership organized in country N that is owned in equal parts by LC1 and LC2, leasing companies that are unrelated to DX. BK, a bank organized in country N and unrelated to DX, LC1 and LC2, lends $100,000,000 to FX to enable FX to purchase the property. On the same day, FX purchases the property and engages in a transaction with DX which is treated as a lease of the property for country N tax purposes but a loan for U.S. tax purposes. Accordingly, DX is treated as the owner of the property for U.S. tax purposes. The parties comply with the requirements of section 881(c) with respect to the debt obligation of DX to FX. FX and DX structured these transactions in this manner so that LC1 and LC2 would be entitled to accelerated depreciation deductions with respect to the property in country N and DX would be entitled to accelerated depreciation deductions in the United States. None of the parties would have participated in the transaction if the payments made by DX were subject to U.S. withholding tax.

(ii) The loan from BK to FX and from FX to DX are financing transactions and, together constitute a financing arrangement. The participation of FX in the financing arrangement reduces the tax imposed by section 881 because payments made to FX, but not BK, qualify for the portfolio interest exemption of section 881(c) because BK is a bank making an extension of credit in the ordinary course of its trade or business within the meaning of section 881(c)(3)(A). Moreover, because DX borrowed the money from FX instead of borrowing the money directly from BK to avoid the tax imposed by section 881, one of the principal purposes of the participation of FX was to avoid that tax (even though another principal purpose of the participation of FX was to allow LC1 and LC2 to take advantage of accelerated depreciation deductions in country N). Assuming that FX would not have participated in the financing arrangement on substantially the same terms but for the fact that BK loaned it $100,000,000, FX is a conduit entity and the financing arrangement is a conduit financing arrangement.

Example 13. Significant reduction of tax. (i) FS owns all of the stock of FS1, which also is a resident of country T. FS1 owns all of the stock of DS. On January 1, 1995, FP contributes $10,000,000 to the capital of FS in return for perpetual preferred stock. On July 1, 1995, FS lends $10,000,000 to FS1. On January 1, 1996, FS1 lends $10,000,000 to DS. Under the terms of the country T-U.S. income tax treaty, a country T resident is not entitled to the reduced withholding rate on interest income provided by the treaty if the resident is entitled to specified tax benefits under country T law. Although FS1 may deduct interest paid on the loan from FS, these deductions are not pursuant to any special tax benefits provided by country T law. However, FS qualifies for one of the enumerated tax benefits pursuant to which it may deduct dividends paid with respect to the stock held by FP. Therefore, if FS had made a loan directly to DS, FS would not have been entitled to the benefits of the country T-U.S. tax treaty with respect to payments it received from DS, and such payments would have been subject to tax under section 881 at a 30 percent rate.

(ii) The FS–FS1 loan and the FS1–DS loan are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(i) of this section, the significant reduction in tax resulting from the participation of FS1 in the financing arrangement is evidence that the participation of FS1 in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 14. Significant reduction of tax. (i) FP owns 90 percent of the voting stock of FX, an unlimited liability company organized in country T. The other 10 percent of the common stock of FX is owned by FP1, a subsidiary of FP that is organized in country N. Although FX is a partnership for U.S. tax purposes, FX is entitled to the benefits of the U.S.-country T income tax treaty because FX is subject to tax in country T as a resident corporation. On January 1, 1996, FP contributes $10,000,000 to FX in exchange for an instrument denominated as preferred stock that pays a dividend of 7 percent and that must be redeemed by FX in seven years. For U.S. tax purposes, the preferred stock is a partnership interest. On July 1, 1996, FX makes a loan of $10,000,000 to DS in exchange for a 7-year note paying interest at 6 percent.

(ii) Because FX is required to redeem the partnership interest at a specified time, the partnership interest constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*2*) of this section. Moreover, because the FX-DS note is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, together the transactions constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Payments of interest made directly by DS to FP and FP1 would not be eligible for the portfolio interest exemption and would not be entitled to a reduction in withholding tax pursuant to a tax treaty. Therefore, there is a significant reduction in tax resulting from the participation of FX in the financing arrangement, which is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the existence of such a plan must also be taken into account.

Example 15. Significant reduction of tax. (i) FP owns a 10 percent interest in the profits and capital of FX, a partnership organized in country N. The other 90 percent interest in FX is owned by G, an unrelated corporation that is organized in country T. FX is not engaged in business in the United States. On January 1, 1996, FP contributes $10,000,000 to FX in exchange for an instrument documented as perpetual subordinated debt that provides for quarterly interest payments at 9 percent per annum. Under the terms of the instrument, payments

on the perpetual subordinated debt do not otherwise affect the allocation of income between the partners. FP has the right to require the liquidation of FX if FX fails to make an interest payment. For U.S. tax purposes, the perpetual subordinated debt is treated as a partnership interest in FX and the payments on the perpetual subordinated debt constitute guaranteed payments within the meaning of section 707(c). On July 1, 1996, FX makes a loan of $10,000,000 to DS in exchange for a 7-year note paying interest at 8 percent per annum.

(ii) Because FP has the effective right to force payment of the ''interest'' on the perpetual subordinated debt, the instrument constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*2*) of this section. Moreover, because the note between FX and DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, together the transactions are a financing arrangement within the meaning of (a)(2)(i) of this section. Without regard to this section, 90 percent of each interest payment received by FX would be treated as exempt from U.S. withholding tax because it is beneficially owned by G, while 10 percent would be subject to a 30 percent withholding tax because beneficially owned by FP. If FP held directly the note issued by DS, 100 percent of the interest payments on the note would have been subject to the 30 percent withholding tax. The significant reduction in the tax imposed by section 881 resulting from the participation of FX in the financing arrangement is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 16. Time period between transactions. (i) On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays no interest annually. When the note matures, FS is obligated to pay $24,000,000 to FP. On January 1, 1996, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 10 percent per annum.

(ii) The FS note held by FP and the DS note held by FS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the short period of time (twelve months) between the loan by FP to FS and the loan by FS to DS is evidence that the participation of FS in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 17. Financing transactions in the ordinary course of business. (i) FP is a holding company. FS is actively engaged in country T in the business of manufacturing and selling product A. DS manufactures product B, a principal component in which is product A. FS' business activity is substantial. On January 1, 1995, FP lends $100,000,000 to FS to finance FS' business operations. On January 1, 1996, FS ships $30,000,000 of product A to DS. In return, FS creates an interest-bearing account receivable on its books. FS' shipment is in the ordinary course of the active conduct of its trade or business (which is complementary to DS' trade or business.)

(ii) The loan from FP to FS and the accounts receivable opened by FS for a payment owed by DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iv) of this section, the fact that DS' liability to FS is created in the ordinary course of the active conduct of DS' trade or business that is complementary to a business actively engaged in by DS is evidence that the participation of FS in the financing arrangement is not pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 18. Tax avoidance plan—other factors. (i) On February 1, 1995, FP issues debt in Country N that is in registered form within the meaning of section 881(c)(3)(A). The FP debt would satisfy the requirements of section 881(c) if the debt were issued by a U.S. person and the withholding agent received the certification required by section 871(h)(2)(B)(ii). The purchasers of the debt are financial institutions and there is no reason to believe that they would not furnish Forms W–8. On March 1, 1995, FP lends a portion of the proceeds of the offering to DS.

(ii) The FP debt and the loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The owners of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Interest payments on the debt issued by FP would be subject to withholding tax if the debt were issued by DS, unless DS received all necessary Forms W–8. Therefore, the participation of FP in the financing arrangement potentially reduces the tax imposed by section 881(a). However, because it is reasonable to assume that the purchasers of the FP debt would have provided certifications in order to avoid the withholding tax imposed by section 881, there is not a tax avoidance plan. Accordingly, FP is not a conduit entity.

Example 19. Tax avoidance plan—other factors. (i) Over a period of years, FP has maintained a deposit with BK, a bank organized in the United States, that is unrelated to FP and its subsidiaries. FP often sells goods and purchases raw materials in the United States. FP opened the bank account with BK in order to facilitate this business and the amounts it maintains in the account are reasonably related to its dollar-denominated working capital needs. On January 1, 1995, BK lends $5,000,000 to DS. After the loan is made, the balance in FP's bank account remains within a range appropriate to meet FP's working capital needs.

(ii) FP's deposit with BK and BK's loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to section 881(i), interest paid by BK to FP with respect to the bank deposit is exempt from withholding tax. Interest paid directly by DS to FP would not be exempt from withholding tax under section 881(i) and therefore would be subject to a 30% withholding tax. Accordingly, there is a significant reduction in the tax imposed by section 881, which is evidence of the existence of a tax avoidance plan. See paragraph (b)(2)(i) of this section. However, the district director also will consider the fact that FP historically has maintained an account with BK to meet its working capital needs and that, prior to and after BK's loan to DS, the balance within the account remains within a range appropriate to meet those business needs as evidence that the participation of BK in the FP–BK–DS financing arrangement is not pursuant to a tax avoidance plan. In determining the presence or absence of a tax avoidance plan, all relevant facts will be taken into account.

Example 20. Tax avoidance plan—other factors. (i) Assume the same facts as in *Example 19*, except that on January 1, 2000, FP's deposit with BK substantially exceeds FP's expected working capital needs and on January 2, 2000, BK lends additional funds to DS. Assume also that BK's loan to DS provides BK with a right of offset against FP's deposit. Finally, assume that FP would have lent the funds to DS directly but for the imposition of the withholding tax on payments made directly to FP by DS.

(ii) As in *Example 19*, the transactions in paragraph (i) of this *Example 20* are a financing arrangement within the meaning of paragraph (a)(2)(i) and the participation of the BK reduces the section 881 tax. In this case, the presence of funds substantially in excess of FP's working capital needs and the fact that FP would have been willing to lend funds directly to DS if not for the withholding tax are evidence that the participation of BK in the FP-BK-FS financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account. Even if the district director determines that the participation of BK in the financing arrangement is pursuant to a tax avoidance plan, BK may not be treated as a conduit entity unless BK would not have participated in the financing arrangement on substantially the same terms in the absence of FP's deposit with BK. BK's right of offset against FP's deposit (a form of guarantee of BK's loan to DS) creates a presumption that BK would not have made the loan to DS on substantially the same terms in the absence of FP's deposit with BK. If the taxpayer overcomes the presumption by clear and convincing evidence, BK will not be a conduit entity.

Example 21. Significant financing activities. (i) FS is responsible for coordinating the financing of all of the subsidiaries of FP, which are engaged in substantial trades or businesses and are located in country T, country N, and the United States. FS maintains a centralized cash management accounting system for FP and its subsidiaries in which it records all

intercompany payables and receivables; these payables and receivables ultimately are reduced to a single balance either due from or owing to FS and each of FP's subsidiaries. FS is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. FS must borrow any cash necessary to meet those external obligations and invests any excess cash for the benefit of the FP group. FS enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of FS are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. FS has 50 employees, including clerical and other back office personnel, located in country T. At the request of DS, on January 1, 1995, FS pays a supplier $1,000,000 for materials delivered to DS and charges DS an open account receivable for this amount. On February 3, 1995, FS reverses the account receivable from DS to FS when DS delivers to FP goods with a value of $1,000,000.

(ii) The accounts payable from DS to FS and from FS to other subsidiaries of FP constitute financing transactions within the meaning of paragraph (a)(2)(ii)(A)(*1*) of this section, and the transactions together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. FS's activities constitute significant financing activities with respect to the financing transactions even though FS did not actively and materially participate in arranging the financing transactions because the financing transactions consisted of trade receivables and trade payables that were ordinary and necessary to carry on the trades or businesses of DS and the other subsidiaries of FP. Accordingly, pursuant to paragraph (b)(3)(i) of this section, FS' participation in the financing arrangement is presumed not to be pursuant to a tax avoidance plan.

Example 22. Significant financing activities—active risk management. (i) The facts are the same as in Example 21, except that, in addition to its short-term funding needs, DS needs long-term financing to fund an acquisition of another U.S. company; the acquisition is scheduled to close on January 15, 1995. FS has a revolving credit agreement with a syndicate of banks located in Country N. On January 14, 1995, FS borrows ¥10 billion for 10 years under the revolving credit agreement, paying yen LIBOR plus 50 basis points on a quarterly basis. FS enters into a currency swap with BK, an unrelated bank that is not a member of the syndicate, under which FS will pay BK ¥10 billion and will receive $100 million on January 15, 1995; these payments will be reversed on January 15, 2004. FS will pay BK U.S. dollar LIBOR plus 50 basis points on a notional principal amount of $100 million semi-annually and will receive yen LIBOR plus 50 basis points on a notional principal amount of ¥10 billion quarterly. Upon the closing of the acquisition on January 15, 1995, DS borrows $100 million from FS for 10 years, paying U.S. dollar LIBOR plus 50 basis points semiannually.

(ii) Although FS performs significant financing activities with respect to certain financing transactions to which it is a party, FS does not perform significant financing activities with respect to the financing transactions between FS and the syndicate of banks and between FS and DS because FS has eliminated all material market risks arising from those financing transactions through its currency swap with BK. Accordingly, the financing arrangement does not benefit from the presumption of paragraph (b)(3)(i) of this section and the district director must determine whether the participation of FS in the financing arrangement is pursuant to a tax avoidance plan on the basis of all the facts and circumstances. However, if additional facts indicated that FS reviews its currency swaps daily to determine whether they are the most cost efficient way of managing their currency risk and, as a result, frequently terminates swaps in favor of entering into more cost efficient hedging arrangements with unrelated parties, FS would be considered to perform significant financing activities and FS' participation in the financing arrangements would not be pursuant to a tax avoidance plan.

Example 23. Significant financing activities—presumption rebutted. (i) The facts are the same as in *Example 21*, except that, on January 1, 1995, FP lends to FS DM 15,000,000 (worth $10,000,000) in exchange for a 10 year note that pays interest annually at a rate of 5 percent per annum. Also, on March 15, 1995, FS lends $10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. FS would not have had sufficient funds to make the loan to DS without the loan from FP. FS does not enter into any long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

(ii) Because FS performs significant financing activities with respect to the financing transactions between FS, DS and FP, the participation of FS in the financing arrangement is presumed not to be pursuant to a tax avoidance plan. The district director may rebut this presumption by establishing that the participation of FS is pursuant to a tax avoidance plan, based on all the facts and circumstances. The mere fact that FS is a resident of country T is not sufficient to establish the existence of a tax avoidance plan. However, the existence of a plan can be inferred from other factors in addition to the fact that FS is a resident of country T. For example, the loans are made within a short time period and FS would not have been able to make the loan to DS without the loan from FP.

Example 24. Determination of amount of tax liability. (i) On January 1, 1996, FP makes two three-year installment loans of $250,000 each to FS that pay interest at a rate of 9 percent per annum. The loans are self-amortizing with payments on each loan of $7,950 per month. On the same date, FS lends $1,000,000 to DS in exchange for a two-year note that pays interest semi-annually at a rate of 10 percent per annum, beginning on June 30, 1996. The FS-DS loan is not self-amortizing. Assume that for the period of January 1, 1996 through June 30, 1996, the average principal amount of the financing transactions between FP and FS that comprise the financing arrangement is $469,319. Further, assume that for the period of July 1, 1996 through December 31, 1996, the average principal amount of the financing transactions between FP and FS is $393,632. The average principal amount of the financing transaction between FS and DS for the same periods is $1,000,000. The district director determines that the financing transactions between FP and FS, and FS and DS, are a conduit financing arrangement.

(ii) Pursuant to paragraph (d)(1)(i) of this section, the portion of the $50,000 interest payment made by DS to FS on June 30, 1996, that is recharacterized as a payment to FP is $23,450 computed as follows: ($50,000 x $469,319/$1,000,000) = $23,450. The portion of the interest payment made on December 31, 1996 that is recharacterized as a payment to FP is $19,650, computed as follows: ($50,000 x $393,632/$1,000,000) = $19,650. Furthermore, under § 1.1441–3(j), DS is liable for withholding tax at a 30 percent rate on the portion of the $50,000 payment to FS that is recharacterized as a payment to FP, i.e., $7,035 with respect to the June 30, 1996 payment and $5,895 with respect to the December 31, 1996 payment.

Example 25. Determination of principal amount. (i) FP lends DM 10,000,000 to FS in exchange for a ten year note that pays interest semi-annually at a rate of 8 percent per annum. Six months later, pursuant to a tax avoidance plan, FS lends DM 5,000,000 to DS in exchange for a 10 year note that pays interest semi-annually at a rate of 10 percent per annum. At the time FP make its loan to FS, the exchange rate is DM 1.5/$1. At the time FS makes its loan to DS the exchange rate is DM 1.4/$1.

(ii) FP's loan to FS and FS' loan to DS are financing transactions and together constitute a financing arrangement. Furthermore, because the participation of FS reduces the tax imposed under section 881 and FS' participation is pursuant to a tax avoidance plan, the financing arrangement is a conduit financing arrangement.

(iii) Pursuant to paragraph (d)(1)(i) of this section, the amount subject to recharacterization is a fraction the numerator of which is the average principal amount advanced from FS to DS and the denominator of which is the average principal amount advanced from FP to FS. Because the property advanced in these financing transactions is the same type of fungible property, under paragraph (d)(1)(ii)(A) of this section, both are valued on the date of the last financing transaction. Accordingly, the portion of the payments of interest that is recharacterized is ((DM 5,000,000×DM 1.4/$1)/(DM 10,000,000×DM 1.4/$1) or 0.5.

(f) *Effective date.* This section is effective for payments made by financed entities on or after September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October

15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

§ 1.881–4 Recordkeeping requirements concerning conduit financing arrangements.

(a) *Scope.* This section provides rules for the maintenance of records concerning certain financing arrangements to which the provisions of § 1.881–3 apply.

(b) *Recordkeeping requirements*—(1) *In general.* Any person subject to the general recordkeeping requirements of section 6001 must keep the permanent books of account or records, as required by section 6001, that may be relevant to determining whether that person is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement.

(2) *Application of Sections 6038 and 6038A.* A financed entity that is a reporting corporation within the meaning of section 6038A(a) and the regulations under that section, and any other person that is subject to the recordkeeping requirements of § 1.6038A–3, must comply with those recordkeeping requirements with respect to records that may be relevant to determining whether the financed entity is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement. Such records, including records that a person is required to maintain pursuant to paragraph (c) of this section, shall be considered records that are required to be maintained pursuant to section 6038 or 6038A. Accordingly, the provisions of sections 6038 and 6038A (including, without limitation, the penalty provisions thereof), and the regulations under those sections, shall apply to any records required to be maintained pursuant to this section.

(c) *Records to be maintained*—(1) *In general.* An entity described in paragraph (b) of this section shall be required to retain any records containing the following information concerning each financing transaction that the entity knows or has reason to know comprises the financing arrangement—

(i) The nature (e.g., loan, stock, lease, license) of each financing transaction;

(ii) The name, address, taxpayer identification number (if any) and country of residence of—

(A) Each person that advanced money or other property, or granted rights to use property;

(B) Each person that was the recipient of the advance or rights; and

(C) Each person to whom a payment was made pursuant to the financing transaction (to the extent that person is a different person than the person who made the advance or granted the rights);

(iii) The date and amount of—

(A) Each advance of money or other property or grant of rights; and

(B) Each payment made in return for the advance or grant of rights;

(iv) The terms of any guarantee provided in conjunction with a financing transaction, including the name of the guarantor; and

(v) In cases where one or both of the parties to a financing transaction are related to each other or another entity in the financing arrangement, the manner in which these persons are related.

(2) *Additional documents.* An entity described in paragraph (b) of this section must also retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrangements. Such documents may include, but are not limited to—

(i) Minutes of board of directors meetings;

(ii) Board resolutions or other authorizations for the financing transactions;

(iii) Private letter rulings;

(iv) Financial reports (audited or unaudited);

(v) Notes to financial statements;

(vi) Bank statements;

(vii) Copies of wire transfers;

(viii) Offering documents;

(ix) Materials from investment advisors, bankers and tax advisors; and

(x) Evidences of indebtedness.

(3) *Effect of record maintenance requirement.* Record maintenance in accordance with paragraph (b) of this section generally does not require the original creation of records that are ordinarily not created by affected entities. If, however, a document that is actually created is described in this paragraph (c), it is to be retained even if the document is not of a type ordinarily created by the affected entity.

(d) *Effective date.* This section is effective September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

Par. 4. In § 1.1441–3, the OMB parenthetical at the end of the section is removed and paragraph (j) is added to read as follows:

§ 1.1441–3 Exceptions and rules of special application.

* * * * *

(j) *Conduit financing arrangements*—(1) *Duty to withhold.* A financed entity or other person required to withhold tax under section 1441 with respect to a financing arrangement that is a conduit financing arrangement within the meaning of § 1.881–3(a)(2)(iv) shall be required to withhold under section 1441 as if the district director had determined, pursuant to § 1.881–3(a)(3), that all conduit entities that are parties to the conduit financing arrangement should be disregarded. The amount of tax required to be withheld shall be determined under § 1.881–3(d). The withholding agent may withhold tax at a reduced rate if the financing entity establishes that it is entitled to the benefit of a treaty that provides a reduced rate of tax on a payment of the type deemed to have been paid to the financing entity. Section 1.881–3(a)(3)(ii)(E) shall not apply for purposes of determining whether any person is required to deduct and withhold tax pursuant to this paragraph (j), or whether any party to a financing arrangement is liable for failure to withhold or entitled to a refund of tax under sections 1441 or 1461 to 1464 (except to the extent the amount withheld exceeds the tax liability determined under § 1.881–3(d)). See § 1.1441–7(d) relating to withholding tax liability of the withholding agent in conduit financing arrangements subject to § 1.881–3.

(2) *Effective date.* This paragraph (j) is effective for payments made by financed entities on or after September 11, 1995. This paragraph shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

Par. 5. In § 1.1441–7, the OMB parenthetical at the end of the section is removed and paragraph (d) is added to read as follows:

§ 1.1441–7 General provisions relating to withholding agents.

* * * * *

(d) *Conduit financing arrangements*—(1) *Liability of withholding agent.* Subject to paragraph (d)(2) of this section, any person that is required to deduct and withhold tax under § 1.1441–3(j) is made liable for that tax by section 1461. A person that is required to deduct and withhold tax but fails to do so is liable for the payment

of the tax and any applicable penalties and interest.

(2) *Exception for withholding agents that do not know of conduit financing arrangement*—(i) *In general.* A withholding agent will not be liable under paragraph (d)(1) of this section for failing to deduct and withhold with respect to a conduit financing arrangement unless the person knows or has reason to know that the financing arrangement is a conduit financing arrangement. This standard shall be satisfied if the withholding agent knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A withholding agent that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

(ii) *Examples.* The following examples illustrate the operation of paragraph (d)(2) of this section.

Example 1. (i) DS is a U.S. subsidiary of FP, a corporation organized in Country N, a country that does not have an income tax treaty with the United States. FS is a special purpose subsidiary of FP that is incorporated in Country T, a country that has an income tax treaty with the United States that prohibits the imposition of withholding tax on payments of interest. FS is capitalized with $10,000,000 in debt from BK, a Country N bank, and $1,000,000 in capital from FS.

(ii) On May 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On July 1, 1995, DS sells a number of installment notes, including C's, to FS in exchange for $10,000,000. DS continues to service the installment notes for FS and C is not notified of the sale of its obligation and continues to make payments to DS. But for the withholding tax on payments of interest by DS to BK, DS would have borrowed directly from BK, pledging the installment notes as collateral.

(iii) The C installment note is a financing transaction, whether held by DS or by FS, and the FS note held by BK also is a financing transaction. After FS purchases the installment note, and during the time the installment note is held by FS, the transactions constitute a financing arrangement, within the meaning of § 1.881–3(a)(2)(i). BK is the financing entity, FS is the intermediate entity, and C is the financed entity. Because the participation of FS in the financing arrangement reduces the tax imposed by section 881 and because there was a tax avoidance plan, FS is a conduit entity.

(iv) Because C does not know or have reason to know of the tax avoidance plan (and by extension that the financing arrangement is a conduit financing arrangement), C is not required to withhold tax under section 1441. However, DS, who knows that FS's participation in the financing arrangement is pursuant to a tax avoidance plan and is a withholding agent for purposes of section 1441, is not relieved of its withholding responsibilities.

Example 2. Assume the same facts as in *Example, 1* except that C receives a new payment booklet on which DS is described as ''agent''. Although C may deduce that its installment note has been sold, without more C has no reason to know of the existence of a financing arrangement. Accordingly, C is not liable for failure to withhold, although DS still is not relieved of its withholding responsibilities.

Example 3. (i) DC is a U.S. corporation that is in the process of negotiating a loan of $10,000,000 from BK1, a bank located in Country N, a country that does not have an income tax treaty with the United States. Before the loan agreement is signed, DC's tax lawyers point out that interest on the loan would not be subject to withholding tax if the loan were made by BK2, a subsidiary of BK1 that is incorporated in Country T, a country that has an income tax treaty with the United States that prohibits the imposition of withholding tax on payments of interest. BK1 makes a loan to BK2 to enable BK2 to make the loan to DC. Without the loan from BK1 to BK2, BK2 would not have been able to make the loan to DC.

(ii) The loan from BK1 to BK2 and the loan from BK2 to DC are both financing transactions and together constitute a financing arrangement within the meaning of § 1.881–3(a)(2)(i). BK1 is the financing entity, BK2 is the intermediate entity, and DC is the financed entity. Because the participation of BK2 in the financing arrangement reduces the tax imposed by section 881 and because there is a tax avoidance plan, BK2 is a conduit entity.

(iii) Because DC is a party to the tax avoidance plan (and accordingly knows of its existence), DC must withhold tax under section 1441. If DC does not withhold tax on its payment of interest, BK2, a party to the plan and a withholding agent for purposes of section 1441, must withhold tax as required by section 1441.

Example 4. (i) DC is a U.S. corporation that has a long-standing banking relationship with BK2, a U.S. subsidiary of BK1, a bank incorporated in Country N, a country that does not have an income tax treaty with the United States. DC has borrowed amounts of as much as $75,000,000 from BK2 in the past. On January 1, 1995, DC asks to borrow $50,000,000 from BK2. BK2 does not have the funds available to make a loan of that size. BK2 considers BK1 to enter into a loan with DC but rejects this possibility because of the additional withholding tax that would be incurred. Accordingly, BK2 borrows the necessary amount from BK1 with the intention of on-lending to DC. BK1 does not make the loan directly to DC because of the withholding tax that would apply to payments of interest from DC to BK1. DC does not negotiate with BK1 and has no reason to know that BK1 was the source of the loan.

(ii) The loan from BK2 to DC and the loan from BK1 to BK2 are both financing transactions and together constitute a financing arrangement within the meaning of § 1.881–3(a)(2)(i). BK1 is the financing entity, BK2 is the intermediate entity, and DC is the financed entity. The participation of BK2 in the financing arrangement reduces the tax imposed by section 881. Because the participation of BK2 in the financing arrangement reduces the tax imposed by section 881 and because there was a tax avoidance plan, BK2 is a conduit entity.

(iii) Because DC does not know or have reason to know of the tax avoidance plan (and by extension that the financing arrangement is a conduit financing arrangement), DC is not required to withhold tax under section 1441. However, BK2, who is also a withholding agent under section 1441 and who knows that the financing arrangement is a conduit financing arrangement, is not relieved of its withholding responsibilities.

(3) *Effective date.* This paragraph (d) is effective for payments made by financed entities on or after September 11, 1995. This paragraph shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

Par. 6. In § 1.6038A–3, paragraphs (b)(5) and (c)(2)(vii) are added to read as follows:

§ 1.6038A–3 Record maintenance.

* * * * *

(b) * * *

(5) *Records relating to conduit financing arrangements.* See § 1.881–4 relating to conduit financing arrangements.

(c) * * *

(2) * * *

(vii) *Records relating to conduit financing arrangements.* See § 1.881–4 relating to conduit financing arrangements.

* * * * *

Par. 7. Section 1.7701(l)–1 is added to read as follows:

§ 1.7701(l)–1 Conduit financing arrangements.

(a) *Scope.* Section 7701(l) authorizes the issuance of regulations that recharacterize any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by title 26 of the United States Code.

(b) *Regulations issued under authority of section 7701(l).* The following regulations are issued under the authority of section 7701(l)—

(1) § 1.871–1(b)(7);
(2) § 1.881–3;
(3) § 1.881–4;
(4) § 1.1441–3(j);
(5) § 1.1441–7(d);
(6) § 1.6038A–3(b)(5); and
(7) § 1.6038A–3(c)(2)(vii).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In § 602.101, paragraph (c) is amended by adding an entry in numerical order and revising an entry to the table to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * *	*
1.881–4	1545–1440
* * * *	*
§ 1.6038A–3	1545–1191 1545–1440
* * * *	*

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: July 26, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

[FR Doc. 95–19446 Filed 8–10–95; 8:45 am]

BILLING CODE 4830–01–U

DEPARTMENT OF LABOR

Office of the Secretary

29 CFR Part 20

Federal Claims Collection; Collection of Debts by Federal Income Tax Refund Offset

AGENCY: Office of the Secretary, Labor.

ACTION: Final rule; interim rule adopted as final with changes.

SUMMARY: The Department of Labor is completing its rulemaking to implement the requirement of the Cash Management Improvement Act Amendments of 1992 that Federal agencies refer delinquent debt to the Internal Revenue Service (IRS) for collection by offset from a Federal income tax refund that may be due to the delinquent debtor. These regulations are necessary for the Department's participation in the IRS offset program. The IRS offset program has proven to be a cost-effective mechanism for collection of delinquent debt.

EFFECTIVE DATE: These regulations are effective September 11, 1995.

FOR FURTHER INFORMATION CONTACT: Robert Barnhard, Division of Planning and Internal Control, Office of Financial Integrity, Office of the Chief Financial Officer, Department of Labor, Room S–4502, 200 Constitution Avenue, NW., Washington, DC 20210, telephone number 202/219–8184.

SUPPLEMENTARY INFORMATION: In 1992 the Congress passed and the President signed into law the Cash Management Improvement Act Amendments of 1992, which requires Federal agencies to participate in the IRS income tax refund offset program. On September 15, 1994 the Department of Labor published in the **Federal Register** an interim rule with request for comments implementing the IRS income tax refund offset program. The interim rule established a new Subpart E which specifies the procedures the Department of Labor will follow with regard to referral by its constituent offices, administrations and bureaus of past-due legally enforceable debts to IRS for collection by income tax refund offset.

The interim rule also established a new title for 29 CFR part 20: Federal Claims Collection. In addition to the new subpart E, part 20 contains the Department's regulations implementing the Debt Collection Act of 1982 (DCA). Subpart A implements the credit reporting provisions of the DCA; Subpart B, adminstrative offset; Subpart C, assessment of interest, penalties and administrative costs; and Subpart D, salary offset.

No comments were received in response to the notice of interim rulemaking with request for comments. Comments were to be submitted on or before November 14, 1994. However, two changes are made with the adoption of the interim rule as final due to changes in IRS requirements for participation in the offset program. In § 20.105 the specified minimum amounts for individual debts and business debts otherwise eligible for referral have been deleted. Section 10.106(b) is amended to delete reference to the requirement that business debts be referred to a commercial credit reporting agency.

Publication in Final

The Department of Labor has determined pursuant to 5 U.S.C. 553(b)(B) that good cause exists for waiving public comment on the changes to § 20.105 and § 20.106(b) set forth in this document. These changes merely reflect the change or elimination of certain IRS requirements for participation in the offset program. Therefore, public comment is unnecessary.

Executive Order 12866

This final rule is not classified as a ''significant rule'' under Executive Order 12866 on Federal regulations, because it will not result in (1) an annual effect on the economy of $100 million or more; (2) a major increase in costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) significant adverse effects on competition, employment, investment, productivity, innovation, or on the ability of United States-based enterprises to compete with foreign-based enterprises in domestic or foreign markets. Accordingly, no regulatory impact assessment is required.

Regulatory Flexibility Act

Because no notice of proposed rulemaking has occurred during this rulemaking, the requirements of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) pertaining to regulatory analyses do not apply.

Paperwork Reduction Act

This final rule is not subject to Section 3504(h) of the Paperwork Reduction Act (44 U.S.C. 3501) since it does not contain any new information collection requirements.

List of Subjects in 19 CFR Part 20

Government employees, Loan programs, Credit, Administrative practice and procedure, Claims.

Accordingly, the interim rule amending part 20 of title 29 of the Code of Federal Regulations which was published at 59 FR 47249 on September 15, 1994 is adopted as a final rule with the following changes:

PART 20—FEDERAL CLAIMS COLLECTION

1. The authority citation for Part 20 continues to read as follows:

Authority: 31 U.S.C. 3711 *et seq.;* Subpart D is also issued under 5 U.S.C. 5514; Subpart E is also issued under 31 U.S.C. 3720A.

2. Section 20.105 is revised to read as follows: