tax notes

Volume 146, Number 9 ■ April 27, 2015

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Reprinted from *Tax Notes*, April 27, 2015, p. 409

taxanalysts®

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In this report, Daub examines the conduit regulations and explains how 20 years after their finalization, these critical rules governing the U.S. taxation of cross-border financings leave many interpretative questions unresolved.

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It has been over 20 years since Congress enacted section 7701(l) through the Revenue Reconciliation Act of 1993 (the 1993 act).[1] The provision authorizes the IRS to issue regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of its parties if it is determined that recharacterization is appropriate to prevent the avoidance of U.S. tax. The IRS quickly exercised that delegation of broad powers in 1994 by proposing the conduit regulations under reg. section 1.881-3 (IL-64-93) and finalizing them in 1995 (T.D. 8611). Those regulations allow the IRS to recharacterize a multiple-party financing transaction for purposes of applying the 30 percent withholding tax on U.S.-source fixed or determinable annual or periodic income derived by a foreign person and not effectively connected with that person's conduct of a trade or business in the United States.[2]

In 2011, the IRS issued final rules (T.D. 9562) that make a single but important change to the conduit regulations. Otherwise, with a few paltry exceptions,[3] the IRS has steadfastly refused to rule on or provide formal guidance on the meaning of critical concepts articulated in the 1995 final regulations.[4] And although a flurry of bar reports and articles accompanied the 1993 act, the proposed regulations, and the 1995 final regulations,[5] there has effectively been no commentary for almost two

[1] Added to the code by section 13238 of the Omnibus Budget Reconciliation Act of 1993, P.L. 103-66.

[2] Sections 881(a), 1441, and 1442.

[3] FSA 199950002; FSA 200206008; FSA 200227006; NSAR 020101 (Apr. 15, 2002).

[4] Rev. Proc. 2015-7, 2015-1 IRB 231, section 4.01(31) (The IRS will not ordinarily issue a ruling on "whether an intermediate entity is a conduit entity under section 1.881-3(a)(4); whether a transaction is a financing transaction under section 1.881-3(a)(2)(ii); whether the participation of an intermediate entity in a financing arrangement is pursuant to a tax avoidance plan under section 1.881-3(b); whether an intermediate entity performs significant financing activities under section 1.881-3(b)(3)(iii); [and] whether an unrelated intermediate entity would not have participated in a financing arrangement on substantially the same terms under section 1.881-3(c).").

[5] *See, e.g.*, New York State Bar Association, "Report With Respect to Issues to Be Addressed by Regulations Under Sections 163(j) and 7701(l)" (Jan. 24, 1994); NYSBA, "Report on Proposed Regulations Issued Under Section 7701(l) of the Internal Revenue Code" (Dec. 16, 1994); Edward Hawkins, Sam Black, and Mitchell S. Thompson, "The Conduit Regulations: A Primer," 46 *Tax Executive* 492 (1994); Robert W. Toan, Brett L. Gold, and Kevin J. Liss, "The Anti-Conduit Regulations: Working Through Some Additional Examples," 21 *Int'l Tax J.* 35 (1995); Thomas P. North and Mark H. French, "Final Conduit Financing Regs Examined," *Tax Notes*, Oct. 16, 1995, p. 347; Jim Fuller, "U.S. Tax Review," *Tax Notes Int'l*, Aug. 28, 1995, p. 573, at p. 577; Michael Hirschfeld, "Final Regs. Refine Rules on Abusive Conduit Financing," 13 *J. Int'l Tax'n* 484 (1995); Alan S. Lederman and Bobbe Hirsh, "Conduit Proposed Regulations Are Potent in Effect, but Limited in Scope," 82 *J. Tax'n* 116 (1995).

decades on how these important regulations work in practice. This report attempts to fill at least some of that gap.

One might ask at the outset whether the conduit regulations still make a difference in tax planning. The 1993 act and the regulations that followed marked a milestone in the IRS's then-long-standing efforts (punctuated by judicial successes[6] and published guidance[7]) to combat treaty shopping by third-country residents — especially in attempts to avoid the 30 percent withholding tax. When the 1993 act was adopted, 20 U.S. income tax treaties lacked a limitation on benefits article, the purpose of which is to curtail the kind of abuse the conduit regulations are designed to prevent. Only a handful of U.S. treaties now lack LOB articles.[8] However, several common financing structures meet the requirements of the most modern LOB provision but still must be analyzed under the conduit regulations, often with uncertain results.

The conduit regulations can also thwart an otherwise ineligible person from securing the portfolio interest exemption[9] by inserting a purportedly qualifying intermediary entity. Moreover, the legislative history of the 1993 act clarifies that Congress expected the IRS to exercise its authority to address conduit issues not only concerning the 30 percent gross basis tax, but also in other areas — such as the use of multiple controlled foreign corporations to avoid an inclusion under section 951(a)(1)(B) for CFC earnings invested in U.S. property, as defined under section 956.[10] Therefore, the detailed concepts that the IRS has developed to address avoidance of the 30 percent tax might by analogy apply in interpreting more barebones anti-conduit principles that the IRS has articulated to prevent avoidance of provisions such as section 951(a)(1)(B) (in conjunction with section 956[11]) and section 304.[12]

Finally, the concepts developed in the conduit regulations may be relevant in identifying the beneficial owner of income under U.S. income tax treaties and perhaps under other treaties.[13] Accordingly, for better or worse, the conduit regulations are still very much with us.

Although extensive examples accompany the conduit regulations, they are of frustratingly limited use because they largely illustrate only the easy cases. This report examines some of the hard cases for which the IRS has yet to provide guidance. It is organized more or less in the order in which the regulations are written and discusses significant interpretative issues raised by real-life situations. Some of the examples provided in the text are drawn directly from the conduit regulations (but the numbering is my own). This report focuses on the ambiguities that the regulations create when they define the critical terms ''financing arrangement'' and ''tax avoidance plan.'' It also discusses the lack of IRS guidance on how the IRS will determine the effect of a collapsed transaction, and the problems that this lack of guidance has caused.

I. Introduction

For readers unfamiliar with the conduit regulations, the following basic example illustrates how they work. Suppose A lends money to B, for which B pays interest to A, and B turns around and lends that money to C, for which C pays interest to B.

The regulations give the IRS authority to collapse the loans and treat A as having lent money to C. As a result, the IRS will treat A, rather than B, as having derived interest from C for purposes of the 30 percent withholding tax. In the language of the preamble, the conduit regulations permit the IRS ''to disregard, for purposes of section 881, the participation of one or more intermediate entities in a financing arrangement where such entities are

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[6] *Aiken Indus. Inc. v. Commissioner*, 56 T.C. 925 (1971); *Del Commercial Properties Inc. v. Commissioner*, 251 F.3d 210 (D.C. Cir. 2001). *But compare with Northern Indiana Public Service Co. v. Commissioner*, 105 T.C. 341 (1995), *aff'd*, 115 F.3d 506 (7th Cir. 1997).

[7] Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 87-89, 1987-2 C.B. 195.

[8] These include treaties with Greece (1950); Pakistan (1957); the Philippines (1976); Romania (1973); and jurisdictions under the former Soviet Union (1973), which do not present significant opportunities for treaty shopping. The existing treaty with Hungary (1979) also lacks an LOB article, but pending full Senate approval, it will soon be replaced by a treaty containing a modern LOB article.

[9] Sections 871(h), 881(c), and 1441(c)(10).

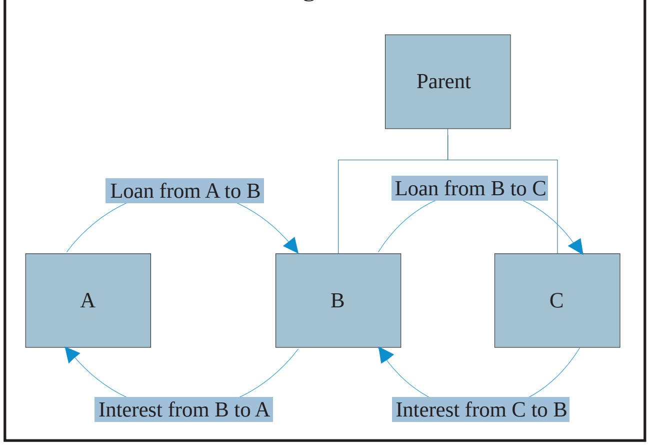
[10] *See* S. Rep. No. 103-37, at 177 (1993). *See also* H.R. Rep. No. 103-111, at 729 (1993); and H.R. Conf. Rep. No. 103-213, at 555 (1993). The only other regulations issued under the authority of section 7701(l) concern so-called fast-pay stock. In addition, the IRS has recently announced that it intends to issue regulations under section 7701(l) to address certain ''de-control'' transactions associated with corporate inversions that eliminate or significantly dilute U.S. ownership in controlled foreign corporations. Notice 2014-52, 2014-42 I.R.B. 712, section 3.02(e). Under those regulations, a non-CFC foreign affiliate's acquisition of an interest in a CFC is recharacterized as a series of transactions involving the foreign affiliate, CFC, and a U.S. shareholder. Both the fast-pay and de-control rules, where they apply, increase the number of parties/transactions involved. Section 7701(l) permits the commissioner only to recharacterize a transaction among parties as ''directly among two or more of such parties'' and thus suggests that it applies only where the effect is to *reduce* the number of parties/transactions. The conduit regulations are consistent with this interpretation, but the fast-pay and de-control rules are not.

[11] Reg. section 1.956-1T(b)(4).

[12] Reg. section 1.304-4T.

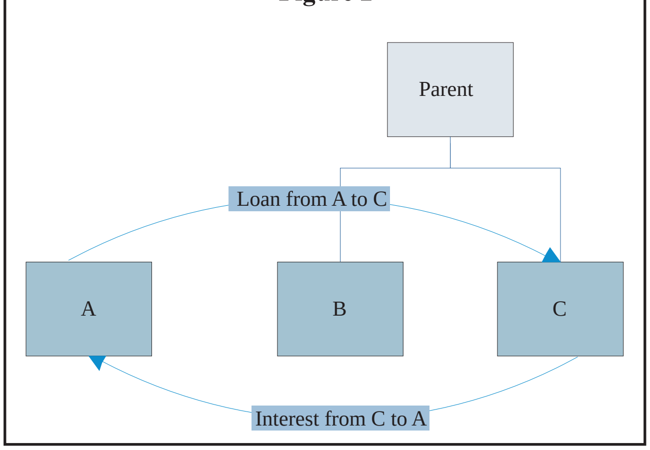
[13] *See generally* para. 2(12) of the commentary to art. 10 of the OECD model treaty.

Figure 1



acting as conduit entities.''[14] In this example, B is the conduit entity, and the IRS is disregarding B's participation in the loan because it appears that the parties intended the loan proceeds from the A-to-B loan to go to C.

Figure 2



The IRS has this authority only when collapsing the loans would increase the amount of the tax. Thus, the IRS can treat A as lending directly to C only if A would be subject to more tax than would B on interest derived from C. The tax owed by A could be higher than the tax owed by B for many reasons. For example, if A is not entitled to a treaty exemption or the portfolio interest exemption to which B would be entitled, A would owe more tax than B if the loans were collapsed.

II. Financing Arrangements

For the IRS to exercise its authority to collapse a transaction, there must be a financing arrangement. The regulations define a financing arrangement as:

> a series of transactions by which one person (the financing entity) advances money or other property, . . . and another person (the financed entity) receives money or other 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.[15]

A. 'Person'

As amended on December 9, 2011, the conduit regulations treat a disregarded entity as a person.[16] The following illustration is given:

> **Example 1:** On January 1, 1996, Foreign Parent (FP) lends $1 million to Domestic Subsidiary (DS) in exchange for a note issued by DS. On January 1, 1997, FP assigns the DS note to Foreign Subsidiary (FS) in exchange for a note issued by FS. After receiving notice of the assignment, DS remits payments due under its note to FS. FS is an entity that is disregarded as an entity separate from its owner, FP.[17]

The example treats FS as an intermediate entity, the DS note held by FS and the FS note held by FP as financing transactions, and the two transactions together as a financing arrangement.

The treatment of a disregarded entity as a person for these purposes undoubtedly lies within the broad granting of authority to the IRS under section 7701(l). As explained below, many transactions structured before December 9, 2011, arguably avoided the impact of the conduit regulations because one or more of the participants in what would otherwise be a financing arrangement were disregarded entities. Accordingly, the effective date of the regulations — and more broadly, the law as it applied before December 9, 2011 — are critical.

The amended regulations state that the treatment of a disregarded entity as a person and the treatment of payments as potentially ineligible for tax benefits are effective only for payments made on or after December 9, 2011.[18] The preamble duly notes that no inference should be drawn regarding the treatment of financing transactions entered into with disregarded entities before the effective date of the final regulations. As the IRS views its change to the meaning of the term ''person'' as a mere clarification, however, it presumably could take the

[14]Reg. section 1.881-3(a)(1).

[15]Reg. section 1.881-3(a)(2)(i)(A).

[16]Reg. section 1.881-3(a)(2)(i)(C).

[17]Reg. section 1.881-3(e), Example 3.

[18]Reg. section 1.881-3(f).

position that such change applies to financing transactions retroactively from the effective date of the original conduit regulations.[19]

The case for treating disregarded entities as persons before December 9, 2011, is weak. Before that date, the regulations contained no definition of the term ''person.'' It was thus necessary to resort to the general definition used in the code, which in section 7701(a) provides that the term ''shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.''[20] If an entity is treated as a disregarded entity, ''its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner.''[21] The section 7701(a)(1) definition of person is limited to distinct legal entities, whereas a sole proprietorship, branch, or division is not a distinct legal entity.[22] However, the language introducing all the definitions in section 7701, including the definition of person, provides an exception for situations in which the meaning as set out in the subsections of section 7701 is ''otherwise [in other code sections] distinctly expressed'' or ''manifestly incompatible with the intent'' of the code.

In a relatively recent case, *Pierre v. Commissioner*,[23] the Tax Court considered whether the transfer to a trust of an interest in a single-member limited liability company classified as a disregarded entity under the check-the-box regulations should be treated as a transfer of the underlying assets to the trust for federal gift tax valuation purposes. That treatment, under the check-the-box regulations, would have resulted in a higher valuation because a direct interest in assets is more valuable than a noncontrolling interest in a legal entity that holds the assets. In a reviewed opinion (with eight judges dissenting), the court held that treating the LLC as a collection of assets (and thus as a disregarded entity) for this purpose rather than as an entity would be manifestly incompatible with the intent of the gift tax — in particular with case law holding that interests subject to the gift tax are defined under state, not federal, law.

Although the IRS has not addressed whether a disregarded entity should be treated as an entity or a person under the ''manifestly incompatible'' language for income tax purposes, it has used that language to suggest a departure from other definitions in section 7701 for income tax purposes, especially when the agency perceives that application of the definition would promote tax avoidance. In a notable field service advice (FSA 200117019), the IRS argued that it would be manifestly incompatible with many code provisions for an entity dually incorporated in a state and a foreign treaty jurisdiction to be treated as a domestic corporation (and thus for its parent to exclude dividends from it under the consolidated return regulations) when it claimed an exemption from U.S. tax on its income as a resident of the treaty jurisdiction.

The IRS could argue that not treating disregarded entities as persons for purposes of the conduit regulations would be manifestly incompatible with the purpose of section 7701(a)(1). Otherwise, the reasoning goes, taxpayers could establish conduit financing structures to avoid the 30 percent tax by simply electing to treat the intermediate entities as disregarded entities. A point in favor of this argument is that when the conduit regulations were finalized in August 1995, the proposed check-the-box regulations had not yet been issued (that happened in May 1996) and it was uncertain whether foreign entities would be included in the new entity classification system, which had been first announced in Notice 95-14.[24] When the final conduit regulations were released, it was unclear whether there was such a thing as a disregarded entity, so the potential to avoid the regulations by relying on the section 7701(a)(1) definition of person was minimal or nonexistent. Once the check-the-box regulations were promulgated, the argument goes, to interpret the conduit regulations' use of the term ''person'' strictly in accordance with the language of section 7701(a)(1) would be manifestly incompatible with the intent of the check-the-box regulations.

The counterargument is that in the nearly 20 years since it first developed the check-the-box system, the IRS has had ample opportunity to think through the implications of that system and establish exceptions to the definition of person to cover situations in which it would be manifestly incompatible with the purposes of the code not to treat a disregarded entity as a person. The IRS has in fact carved out major exceptions on several occasions.

[19]Notice of Proposed Rulemaking, REG-113462-08, 73 F.R. 78,254 (Dec. 22, 2008) (''These proposed regulations *clarify* that a disregarded entity is a person for purposes of section 1.881-3'' (emphasis added).).

[20]Section 7701(a)(1).

[21]Reg. section 301.7701-2(a).

[22]*See also* ITA 200019042 (''Because a single-owner LLC that is disregarded as an entity separate from its owner is not a 'person', nor is it 'liable to tax', the [IRS Philadelphia Service Center] may not certify that the LLC is a resident of the United States.'').

[23]133 T.C. 24 (2009).

[24]1995-1 C.B. 297. The notice states: ''Because the complexities and resources devoted to classification of domestic unincorporated business organizations are mirrored in the foreign context, the IRS and Treasury are considering simplifying the classification rules for foreign organizations in a manner consistent with the [elective] approach described above for domestic organizations.''

The most relevant may be the IRS's attempt in late 1999 to shut down a perceived abuse of the check-the-box regulations to avoid a subpart F inclusion on the disposition of a CFC interest through the use of ''check and sell'' transactions. A CFC's gain from the sale of stock is foreign personal holding company income (FPHCI)[25] and thus subpart F income, but its gain from the sale of property used in a trade or business is not.[26] To avoid the current inclusion, a taxpayer would have its first-tier CFC check the box to treat its subsidiary as a disregarded entity and then sell that entity. The taxpayer would claim that the gain was not FPHCI because it was derived from the sale of assets used in the first-tier CFC's trade or business.

On November 29, 1999, the IRS proposed regulations (REG-110385-99) that would have applied when a foreign eligible entity classified as a corporation for federal income tax purposes elected disregarded entity status and within a specified period (beginning one day before and ending 12 months after the classification change) was the subject of an ''extraordinary transaction,'' such as the sale of an interest in the entity. The proposed regulations would have treated the entity as a corporation despite the classification election.[27]

The proposed regulations were eventually withdrawn, however, without ever being published in final form.[28] They therefore never went into effect. And their preamble contained the familiar caveat that the proposed regulations created no inference regarding the treatment of transactions occurring before the effective date.

In *Dover Corp. v. Commissioner*,[29] the Tax Court rebuffed the IRS's attempt to upset a check-and-sell transaction under prior law. In upholding the taxpayer's position, the court noted that the IRS was free to amend its regulations but that in the absence of the IRS's exercise of that authority, the court had to apply the regulation as written. In reaching this conclusion, the court cited the withdrawn proposed regulations as evidence that the IRS was aware of the potential abuse made possible by the check-the-box regulations. It observed that the proposed regulatory solution would have achieved the precise result the IRS was arguing for. Nevertheless, the court characterized the perceived abuse as ''a problem of [the IRS's] own making'' — a problem that the agency allowed to persist by choosing not to amend the regulations to address it.

[25]Section 954(c)(1)(B)(i).

[26]Section 954(c)(1)(B)(iii); reg. section 1.954-2(e)(3)(ii), (iii), and (iv).

[27]Former prop. reg. section 301.7701-3(h).

[28]*See* Notice 2003-46, 2003-2 C.B. 53.

[29]122 T.C. 324 (2004).

Thus, the *Dover* court clearly articulated a policy of giving full effect to the check-the-box regulations regardless of any potential abuse that might arise from interactions with other areas of the code, and it refused to create a judicial exception when the IRS, well aware of the abuse, had not amended its regulations accordingly.

Similarly, taxpayers' use of disregarded entities in financing transactions had long been on Treasury's and the IRS's radar, yet they took no action until the IRS proposed to expand the definition of person in 2008. Thus, in a hypothetical IRS challenge to structures in existence before December 9, 2011, a court would likely exercise restraint and hold the agency to the pre-amended conduit regulations as written. The conduit regulations obviously have not induced reliance on state law in defining property rights, as in estate tax valuation cases — the consideration that drove *Pierre*, a decision that commanded only a bare majority of the Tax Court in any event.

B. An 'Advance' of 'Money or Other Property'

Example 2: A issues its debt to B in exchange for the stock of B's subsidiary, C. B controls both A and C for purposes of section 304, so the issuance is a distribution by A of its (and, if necessary, C's) earnings and profits to B. D, another member of the group, advances cash to B in exchange for B's debt.

D's advance of cash to B is clearly an advance of money. Is B's transfer of C stock to A an advance of other property? Apparently so, even though we tend to think of the prototypical conduit situation as an advance of money by a Cayman Islands company to a Dutch company, followed by an advance of money by the Dutch company to a U.S. company. The regulations cast a broad net.

C. 'A Series of Transactions'

One of the most important issues raised by the conduit regulations is the question of when ''a series of transactions'' exists. Large multinational corporations routinely transfer funds among subsidiaries in different countries. If the IRS sees these transactions as isolated from one another, no financing arrangement can be said to exist. If, however, the IRS views them at the macro level, seemingly unrelated transactions could be considered a series of transactions and collapsed under the conduit regulations. Unfortunately, the regulations provide little guidance to help practitioners determine when a series of transactions is part of the same financial arrangement. Consider the following example:

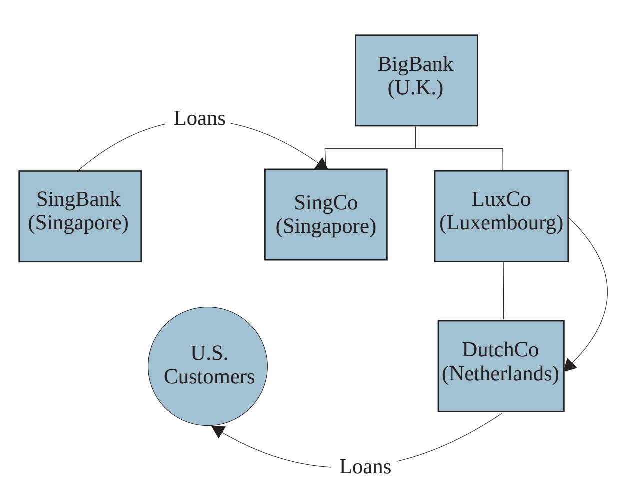
Example 3: BigBank, a U.K.-based bank, indirectly owns a bank subsidiary organized in the Netherlands (DutchCo) that periodically makes loans to customers resident in the United States. Interest on the loans is exempt from U.S. tax under the Netherlands-U.S. income tax treaty.[30] A Luxembourg entity (LuxCo) that is flush with cash and directly owns DutchCo finances DutchCo's operations through loans made for the explicit purpose of on-lending to DutchCo's customers. Under the Luxembourg-U.S. treaty, LuxCo would be eligible for exemption from withholding tax on U.S.-source interest paid to it.[31] All members of the BigBank group that received interest directly from the U.S. customers would not be subject to the 30 percent tax on the interest under either a treaty exemption or the portfolio interest exemption.

A Singaporean non-bank subsidiary of BigBank (SingCo), whose operations are completely separate from those of DutchCo, borrows money from a Singaporean bank (SingBank) on a long-term basis to finance the export sales of Singaporean manufacturers. Interest derived by SingBank, if deemed derived from a U.S. borrower, would be ineligible for a treaty exemption or the portfolio interest exemption (the latter because the interest would be deemed interest "received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business" under section 881(c)(3)(A)). In timing and amount, the loans by SingBank bear no relationship to the loans to DutchCo and from DutchCo to the customers.

This fact pattern illustrates the difficulty of determining whether a series of transactions exists, and thus whether there is a potential problem under the conduit regulations. The issue is whether, in planning a series of plainly related transactions that should not be recharacterized under the conduit regulations, a group can isolate those transactions from unrelated transactions that it may undertake now or in the future and that the IRS might inappropriately attempt to link to the series.

A financing arrangement involving LuxCo, DutchCo, and the U.S. customers would not present a problem because LuxCo would be eligible for a treaty exemption and a direct loan from LuxCo to the U.S. customers therefore would not trigger U.S. tax. Thus, because the participation of DutchCo does not reduce U.S. tax, that financing arrangement would not cause LuxCo to be considered the lender to the U.S. customers.[32]

Figure 3



Even a financing arrangement that also involved SingBank would probably not cause a problem. This is because LuxCo's participation in that financing arrangement would likely not be deemed a tax avoidance plan — one of the requisites for exercise of the IRS's authority.[33] As discussed in Section IV below, two of the factors pointing toward the presence of a tax avoidance plan[34] would be absent because of LuxCo's ability to make an advance from its own funds and the lack of synchronicity between the SingBank loans and either the LuxCo or DutchCo loans. Thus, the loan from LuxCo, even if deemed to have been made directly to the U.S. borrowers, should be respected. On this basis, any loan from SingBank, even if not respected under the regulations as made to SingCo, would, if deemed made to LuxCo, be recharacterized under the regulations as a transaction directly between the remaining parties to the financing arrangement.[35] Interest derived by SingBank from LuxCo would, of course, be foreign-source income not subject to the 30 percent tax. However, a direct loan from SingBank to the U.S. customers would not qualify for exemption.

The question therefore becomes whether the IRS can, by bypassing LuxCo, assert that there is a series of financing transactions linking SingBank, DutchCo, and the U.S. customers, but *not* LuxCo, even though LuxCo directly finances DutchCo to allow it to make on-loans to its customers.

Although the regulations do not define the term "series of transactions," according to dictionaries, a

[30]Netherlands-U.S. treaty, arts. 12 and 26(3).
[31]Luxembourg-U.S. treaty, arts. 12 and 24(4).

[32]Reg. section 1.881-3(a)(4)(i)(A).
[33]Reg. section 1.881-3(b).
[34]Reg. section 1.881-3(b)(2)(ii) and (iii).
[35]Reg. section 1.881-3(a)(3)(ii)(A).

series is "a number of objects or events arranged or coming one after the other in succession"[36] or "a number of things, events, or people of a similar kind or related nature coming one after another."[37] Consistent with these definitions, the regulations' examples do not provide a single illustration of a financing arrangement that does not include, as a participant in the financing arrangement, a person whose advance to the actual lender clearly coincides with the loan to the financed entity.

Any similarity between the timing and amount of an advance from LuxCo and the loans to the customers will not be purely coincidental and will indeed be for the purpose of funding the loans. The inclusion of LuxCo is also consistent with the dictionary definitions above. Thus, any financing arrangement involving loans to the customers should include the participation of LuxCo either as a distinct intermediate entity or as a part of one or more constructed intermediate entities that consist of two or more entities.[38] With LuxCo involved, there should be no conduit entity.

Yet this conclusion is hardly free from doubt. Notably, the regulations provide that the "director of field operations has discretion to determine . . . the financing transactions and parties composing the financing arrangement."[39] Arguably, that discretion has limits. The examples uniformly treat as financing arrangements only two or more financing transactions that seem almost physically linked; there are no examples linking two completely unrelated business operations; and the regulations use the word "series." For those reasons, the director is constrained from conjuring financing arrangements at whim simply based on the presence of two loans in the right direction within the system. Perhaps at odds with other regulations, the conduit regulations do not fully embrace the fungibility of money.

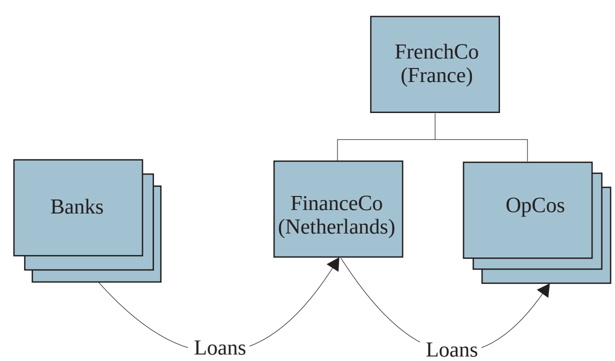
The larger point is that given the breadth of the conduit regulations, it can be exceedingly difficult for a far-flung multinational with diverse operations to be confident that an intercompany loan or other loan that appears to qualify for exemption does in fact qualify — or, perhaps even more difficult, will *remain* qualified — when, unbeknownst to those in charge of servicing the loan, others in the enterprise will later enter into arrangements that may threaten the exemption.

[36]*Available at* http://www.thefreedictionary.com/series.
[37]*Available at* http://dictionary.reference.com/browse/series.
[38]Reg. section 1.881-3(a)(2)(i)(B).
[39]Reg. section 1.881-3(a)(3)(i).

D. One or Many Financing Arrangements?

Example 4: FrenchCo is a France-based, publicly traded multinational with worldwide operations, including in the United States. It owns a Dutch finance subsidiary (FinanceCo) whose primary mission is to borrow from a syndicate of banks and make loans to FrenchCo's operating affiliates (OpCos). FinanceCo's staff commingles the funds received from the banks. That is, it does not specifically identify funds received from one bank as advanced to any particular OpCo. Most of the banks in the syndicate would qualify for a zero rate of withholding on U.S.-source interest under the treaty between the bank's residence jurisdiction and the United States. Some of the banks, however, would qualify for only a reduced rate, and some would be subject to the statutory rate. In any event, the principal amount of the loans outstanding at any given time from the banks with a zero rate will substantially exceed the principal amount of the loans to all OpCos, including the U.S. OpCos. The timing of the bank loans and the FinanceCo loans roughly coincide, and FinanceCo could not have made its loans without the bank loans.

Figure 4



Absent application of the conduit regulations, FinanceCo's U.S.-source interest would qualify for exemption from U.S. tax under the interest article[40] and the so-called derivative benefits provision[41] of the Netherlands-U.S. treaty. However, because of the syndicated loans, it is uncertain whether FinanceCo would be treated as a conduit in one or more financing arrangements between the banks and the U.S. OpCos.

To make that determination in this complex (but not unusual) situation, one must answer a series of

[40]Netherlands-U.S. treaty, art. 12.
[41]*Id.* at art. 26(3).

questions that depend on the identity of the parties to the financing arrangement and whether there is in fact only one financing arrangement: Does the participation of the intermediate entity (or entities) in the financing arrangement reduce the tax that would otherwise be imposed?[42] If so, does it *significantly* reduce the tax?[43] Because disregarding the conduit entity's participation in a financing arrangement results in its recharacterization as a transaction directly between the remaining parties to the arrangement (in most cases, the financed entity and the financing entity),[44] who are those parties and what is the arrangement?

A financing arrangement is an arrangement "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."[45] Under this view, each bank would be engaged in at least one financing arrangement in which no other bank is engaged, and each OpCo would be engaged in at least one financing arrangement in which no other OpCo would be engaged.

However, is each bank engaged in only one financing arrangement or more than one, perhaps as many arrangements as there are OpCos? Is each OpCo engaged in only one financing arrangement or more than one, perhaps as many arrangements as there are banks? A provision in the conduit regulations states:

> 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.[46] [Emphasis added.]

Under the terms of this regulation, the financed entity might be engaged in more than one financing transaction but only one financing arrangement. In that case, is each bank engaged in one financing arrangement and each OpCo engaged in one financing arrangement? Presumably that would mean that some OpCos are engaged in financing arrangements with only zero-taxed banks and other OpCos may be engaged in transactions with banks subject to a positive rate of tax. This has obvious implications in answering whether the intermediary's participation reduces or *significantly* reduces tax from what it would have been had the intermediary not participated. Yet, the regulations provide no indication of how to associate particular OpCos with particular banks.

In the absence of such a rule, it would seem sensible, despite the contrary suggestion in the quoted regulation, to view each OpCo as engaged in a financing arrangement with *each* bank, with the amount borrowed by the OpCo from FinanceCo prorated among each bank in accordance with the principal amounts of their loans to FinanceCo. As a corollary, in determining the tax that would have been imposed had the financing arrangement(s) been treated as direct loans from the banks to an OpCo, the interest on the OpCo's borrowings should be treated as paid to all the banks in the syndicate, prorated based on the amounts of their advances to FinanceCo. The tax reduction tests can then be applied accordingly.

III. Disregarding an Intermediate Entity

The existence of a conduit entity, a tax avoidance plan, and an adverse recharacterization under the conduit regulations largely depend on what the regulations deem the tax consequences would have been had the intermediate entity or entities not participated in the financing arrangement and whether those tax consequences would have been more burdensome than the tax consequences of the arrangement as respected. As noted, if the IRS determines that the participation of a conduit entity in a financing arrangement should be disregarded, the arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement for purposes of the 30 percent tax.[47]

In determining precisely how the arrangement is to be recharacterized, and thus the amount of the hypothetical tax, the IRS has broad (although arguably circumscribed) latitude — especially in determining the financing transactions and parties composing the financing arrangement.[48] Thus, for example, if treaty-benefited A lends to non-treaty-benefited B, which lends to treaty-benefited C, which lends to U.S. entity D, the IRS has the discretion to treat B rather than A as the financing entity on a direct loan to D. If recharacterized that way, the interposition of C reduces tax, which is a relevant factor in determining whether a conduit entity exists.

A separate critical issue is how to characterize the transaction when its legs or the status of the participants differ in some way. The conduit regulations provide as a general rule that the character of

[42] Reg. section 1.881-3(a)(4)(i)(A).
[43] Reg. section 1.881-3(b)(2)(i).
[44] Reg. section 1.881-3(a)(3)(ii)(A).
[45] Reg. section 1.881-3(a)(2)(i)(A) (emphasis added).
[46] Reg. section 1.881-3(d)(1)(i).
[47] Reg. section 1.881-3(a)(3)(ii)(A).
[48] Reg. section 1.881-3(a)(3)(i).

the payments made to the financing entity (citing interest or rent as examples) determines the character of the payments made on the recharacterized transaction.[49]

This general characterization rule raises the question whether the conduit regulations can result in imposition of the 30 percent tax when the intermediate entity derives income effectively connected with the conduct of a U.S. trade or business. Assuming the financing entity is not engaged in a U.S. trade or business, the income on the transaction directly between the remaining parties would arguably be non-effectively connected FDAP income subject to the 30 percent tax under the general characterization rule. However, one could argue that the conduit regulations were not intended to apply, and do not apply, if the payments on each leg of the transaction would not be subject to the 30 percent tax absent a statutory or treaty exemption. All the examples in the regulations and all the cases and rulings in this area exhibit that fact pattern.

Although the conduit regulations generally provide that the character of the payments made to the financing entity determines the character of the payments made in the recharacterized transaction, this characterization rule:

> 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.[50]

The scope of this critical provision (the special characterization rule) — in particular, the phrase "other similar facts or circumstances relating to" — is unclear. The regulations provide as a single example a financing arrangement involving a deposit by a financing entity with an intermediate entity (a bank) presumably resident in a treaty jurisdiction, and a loan by the intermediate entity to a non-bank financed entity. The general characterization rule would characterize the income on the collapsed transaction by reference to the character of the income on the transaction between the financing entity and the intermediate entity (bank deposit interest eligible for exemption from the 30 percent tax[51]). However, because the "fact or circumstance" of the bank deposit does not exist in the transaction between the intermediate entity and the financed entity, the special characterization rule is triggered and the bank deposit is not taken into account in characterizing the interest on the collapsed transaction.

Although the precise scope of the special characterization rule is uncertain, it appears that its purpose is to prevent a taxpayer from benefiting from any special code or treaty exemption that would apply if the character of the income in the hands of the financing entity were determined based on the transaction between the intermediate entity and the financing entity.

> **Example 5:** A financing entity eligible for exemption from U.S. tax on interest under Country A's U.S. treaty lends money to a related intermediate entity that is eligible for the same exemption under Country B's U.S. treaty. The intermediate entity lends to a related U.S. borrower.

The special characterization rule should not apply to treat the financing entity as subject to the 30 percent tax because a "fact or circumstance relating to" its financing transaction with the intermediate entity, resident in Country B (that is, the financing entity's residence in Country A) is not a "fact or circumstance relating to" the financing transaction between the intermediate entity and the financed entity. If the result were otherwise, a taxpayer could never show that the financing arrangement did not reduce the 30 percent tax because, by definition, the intermediate entity is almost always not resident in the same country as the financing entity.

A more difficult case follows.

> **Example 6:** The financing entity, a Spanish bank, makes a loan to a non-bank intermediate entity. The intermediate entity makes a loan to a related U.S.-financed entity. The Spain-U.S. income tax treaty provides that the United States may not tax interest on long-term loans (five or more years) granted by banks or other financial institutions that are residents of Spain.[52] Otherwise, the rate is 10 percent. The

[49]Reg. section 1.881-3(a)(3)(ii)(B).
[50]*Id.*
[51]Sections 871(i)(2) and 881(d).

[52]Spain-U.S. treaty, art. 11(3)(b). The Spanish treaty is a bit unusual in requiring a five-year term for exemption. However, several other treaties similarly require that the lender be a bank or financial institution in order for the interest to be exempt from U.S. tax. *See, e.g.*, Australia-U.S. treaty, art. 11(3)(b) (zero rate if "the interest is derived by a financial institution which is unrelated to and dealing wholly independently with the payer"); Japan-U.S. treaty, art. 11(3)(c)(i) (zero rate if "the interest is beneficially owned by a resident of [Japan] that

(Footnote continued on next page.)

income tax treaty between the intermediate entity's jurisdiction and the United States reduces the rate to zero.

When a Spanish bank extends a five-year loan to the intermediate entity, the general characterization rule would compare (1) the zero amount of tax on interest paid by the financed entity to the intermediate entity with (2) the zero amount of tax that would be imposed on interest paid by the financed entity to the Spanish bank if the character of the interest is determined by reference to the character of the interest actually paid to the Spanish bank. Since the Spanish bank, based on the general characterization rule, would qualify for exemption from tax on interest paid directly to it by the financed entity, application of the general rule would mean that there is no tax reduction and thus the conduit regulations would not apply.

It seems likely, however, that the special characterization rule would apply instead. The five-year term of the Spanish bank's loan should, in the language of the special rule, be treated as a ''term of . . . the financing transaction to which the financing entity is a party.'' Thus, according to the special rule, this term must *also* apply to ''the financing transaction to which the financed entity is a party'' in order for the exemption under the Spanish treaty to be taken into account in determining that interest hypothetically paid directly by the financed entity to the Spanish bank is exempt. If this term does not apply to the financed entity's transaction (that is, the advance by intermediate entity to the financed entity), the comparison would be between the tax on interest on (1) an intermediate-entity-financed entity loan and (2) a Spanish-bank-financed entity loan in which the Spanish bank qualified only for the rate under the Spanish treaty that applied unconditionally to a Spanish resident qualifying for treaty benefits — that is, the generally applicable rate of 10 percent. The participation of the intermediate entity would have reduced the tax to zero, and the reduction-of-tax requirement would have been satisfied.

One more example:

Example 7: A non-bank financing entity that is not resident in a treaty jurisdiction makes a loan to an intermediate entity that is a bank resident in a jurisdiction whose tax treaty with the United States provides for a zero rate on interest. The intermediate entity makes a loan to the financed entity, the interest on which ''is received by a bank on an extension of credit made pursuant to a loan agreement entered in the ordinary course of its trade or business''[53] (the bank exception) and thus does not qualify for the portfolio interest exemption. All parties are unrelated.

Is the financing entity's status as a person other than a bank a relevant fact or circumstance for purposes of the rule? Literally, that may be the case. Based on the bank deposit example in the regulations, it does not seem entirely far-fetched that the drafters would have required that the intermediate entity as well as the financing entity not be disqualified from the portfolio interest exemption on the basis of the bank exception.

Still, there is a potentially relevant difference between this situation and the bank deposit example in the regulations: In this situation, had the financing entity lent directly to the financed entity, it *would* have been eligible for the portfolio interest exemption, without taking into account any facts or circumstances concerning its actual loan to the intermediate entity. In the example in the regulations, however, because the financing entity's exemption on a hypothetical direct loan to the financed entity depends on attributing the intermediate entity's status as a bank to the financed entity, the interest on the recharacterized transaction would *not* have been eligible for exemption without considering the facts and circumstances concerning the financing entity's actual loan to the intermediate entity.

IV. 'A Tax Avoidance Plan'

Assuming the existence of a financing arrangement, the IRS may disregard an intermediate entity's participation in the arrangement only if the intermediary qualifies as a conduit entity.[54] An intermediate entity is treated as a conduit if the intermediary's participation in the financing arrangement is under a tax avoidance plan.[55] The regulations describe a tax avoidance plan as:

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is . . . a bank (including an investment bank)''); and Portugal-U.S. treaty, art. 11(3)(c) (''interest on a long-term loan (5 or more years) granted by a bank or other financial institution that is a resident of'' Portugal).

[53]Section 881(c)(3)(A).

[54]Reg. section 1.881-3(a)(1).

[55]Reg. section 1.881-3(a)(4)(i)(B). Two other conditions must also be met to treat an intermediate entity as a conduit entity. First, the participation of the intermediate entity (or entities) in the financing arrangement must reduce the tax imposed by section 881. This is 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 if the intermediate entity had not participated (reg. section 1.881-3(a)(4)(i)(A)). Second, the intermediate entity must be related to the financing entity or the financed entity (reg. section 1.881-3(a)(4)(i)(C)(1)), or, if unrelated to either, the intermediate entity would not have participated in the financing arrangement on substantially the same

(Footnote continued on next page.)

> a plan one of the principal purposes of which is the avoidance of tax imposed by section 881 [the 30 percent tax]. 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. . . . 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.[56]

The regulations list three nonexclusive factors to be considered in determining whether the participation of an intermediate entity has as one of its principal purposes the reduction of the 30 percent tax: (1) whether the transaction results in a significant reduction of tax; (2) whether the intermediate entity had the ability to make the advance without advances from the financing entity; and (3) the length of time between the financing transactions.[57]

As a practical matter, the determination of whether an intermediate entity is a conduit will often be based on the number of factors that indicate the existence or nonexistence of a tax avoidance plan. Although the factors are nonexclusive, a practitioner is bound to be more confident about a conclusion based on factors listed in the regulations than one based on unarticulated factors, however reasonable. Because the first factor — a significant reduction in tax — will almost always point toward the existence of a plan, the application of the other two factors will often be decisive in determining whether a tax avoidance plan exists.

terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity (reg. section 1.881-3(a)(4)(i)(C)(2)).

[56]Reg. section 1.881-3(b)(1).

[57]Reg. section 1.881-3(b)(2). There is a fourth factor that applies only when two of the parties are related and are engaged in "the active conduct of complementary or integrated trades or businesses." Reg. section 1.881-3(b)(2)(iv). The application of the factor is limited to situations in which the financing transaction between the related parties 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." *Id.* In my experience, this factor is rarely relevant.

A. 'Significant Reduction in Tax'

As noted, the first nonexclusive factor is whether the participation of the intermediate entity significantly reduces the 30 percent tax based on a comparison with a hypothetical structure resulting from the recharacterization of the transaction as a transaction directly between the financing entity and the financed entity.[58] The regulations state that the intermediate entity's entitlement to a treaty benefit that significantly reduces the tax "is not sufficient, by itself, to establish the existence of a tax avoidance plan."[59]

> **Example 8:** The facts are the same as in Example 4 above. Further assume that if the banks in the syndicate that had actual loans outstanding on January 1, 2012, had instead lent directly to the U.S. OpCos in the same amounts on that date, and if the U.S. tax rate imposed on interest on any hypothetical loan was the general rate provided by the treaty between the bank's residence country and the United States (and not any special treaty rate for banks), the blended rate on the loans (weighted by each bank's actual amount lent) would have been 3 percent.

The conduit regulations provide two relevant examples of a significant tax reduction. In one case, the participation of the intermediate entity reduces the tax rate from the statutory 30 percent rate to zero,[60] and, in the other case, it reduces the tax rate from a blended rate (after application of a treaty benefit) of 27 percent to zero.[61] Because these are large reductions in percentage terms — from 100 percent and 90 percent of the statutory rate, respectively, to zero, the reductions are fairly obviously "significant" and not particularly helpful in determining when a rate reduction is *not* significant.

However, in three other instances involving cross-border investment (and thus undoubtedly familiar to the writers of the regulations), Congress or the IRS has written rules specifying when a tax reduction is sufficiently large to trigger adverse tax consequences.

Before the Tax Reform Act of 1986, a U.S. shareholder[62] in a CFC could defer taxation of income that would otherwise be currently taxable to that shareholder (whether or not distributed) by showing, among other things, "that the effecting of the

[58]Reg. section 1.881-3(b)(2)(i).

[59]*Id.*

[60]Reg. section 1.881-3(e), Example 14.

[61]*Id.* at Example 15.

[62]A U.S. shareholder is a domestic shareholder that owns at least 10 percent of the stock of a foreign corporation. Section 951(b).

transaction giving rise to such income through the controlled non-U.S. corporation [did not have as] one of its significant purposes a substantial reduction of income . . . taxes.''

Regulations interpreted the statutory ''substantial reduction'' as *not* having occurred if the non-U.S. taxes on the income equaled or exceeded 90 percent of the highest U.S. corporate income tax rate.[63] In other words, a tax reduction of at least 10 percent would render the tax reduction safe harbor unavailable and result in current taxation of the income. Congress was so enamored of the regulations' 10 percent reduction test that in TRA 1986 it replaced the statutory ''substantial reduction'' test with an explicit 10 percent reduction test.[64]

A provision in the U.S. anti-deferral regime currently taxes to a CFC's U.S. shareholders the CFC's foreign base company sales income[65] (FBCSI), which is generally income from the sale of a product earned by a corporation resident in a low-tax non-U.S. jurisdiction in which the product is neither manufactured nor consumed. In enacting this provision, Congress realized that a multinational could geographically separate manufacturing and selling activities not only through separate incorporation of those activities but also by having a manufacturing CFC establish a sales branch outside the CFC's residence jurisdiction. Accordingly, Congress furnished the IRS with the authority to treat such a branch as a notional CFC for purposes of the FBCSI rules when use of the branch has ''substantially the same effect as if such branch or similar establishment were a wholly owned subsidiary corporation deriving'' the income earned by the branch.[66] Regulations under this provision state that the use will have this effect if the income allocated to the sales branch is taxed at an effective rate of less than 90 percent of, and at least 5 percentage points less than, the effective rate that would have applied to the income had it been earned in the CFC's residence jurisdiction.[67] Thus, the IRS prescribed a rule under which a rate reduction exceeding 10 percent of the pre-reduction rate potentially triggered adverse income tax consequences.

The IRS promulgated the FBCSI regulations (T.D. 6734) in 1964. Despite its age, the regulations' tax reduction test is particularly relevant because the Clinton administration, having promulgated the conduit regulations in 1995, just 2½ years later, in 1998, incorporated the tax reduction test in another set of anti-deferral regulations.[68] Congressional and taxpayer pressure eventually forced the IRS to withdraw this regulation in its entirety (T.D. 8827). However, because essentially the same policymakers were responsible for both the withdrawn regulation and the conduit regulations (which obviously did survive), the tax reduction test in the former arguably is probative of what the conduit regulations mean by a ''significant'' tax reduction.

In determining whether the financing arrangement effected a significant tax reduction, the conduit regulations provide that one must ''generally'' compare the tax and tax rate that would apply if the financing arrangement were respected with the tax and the tax rate that would apply if the financing entity or entities were deemed to have paid interest directly to the financing entity.[69] Applying this rule literally, the participation of FinanceCo would have caused a rate reduction from 3 percent to zero — a 100 percent rate reduction. It seems clear from the regulations' examples of a significant tax reduction, however, that in prescribing the ''general'' comparison, the regulations' writers were thinking of a situation in which the rate, if the structure were respected, would be zero or close to zero and, if it were not respected, would be the statutory 30 percent rate or close to it.

Although the formulation works well in that situation, it does not when, as here, the interest would have been subject to a low percentage rate even if the structure were collapsed. If, for example, under a collapsed structure only a penny of tax were paid but under a respected structure zero tax would be paid, application of the general comparison (arguably in accordance with the subpart F tests described above) would find a 100 percent rate reduction and a significant reduction.

This is obviously nonsensical in light of the purpose of the ''significant tax reduction'' factor to tease out situations in which the participation of the intermediate entity has tax avoidance as a principal purpose. Accordingly, it is reasonable to look at the reduction from the *statutory* rate when, as here, the statutory rate and the rate that would apply in the event of a recharacterization greatly diverge. In contrast, applying the comparison set out in the

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[63]Former reg. section 1.954-1(b)(4)(ii)(a).

[64]Section 954(b)(4).

[65]Section 954(d).

[66]Section 954(d)(2). The provision also authorizes regulations dealing with sales corporations that establish non-same-country manufacturing branches. Those regulations prescribe essentially the same tax reduction test as the sales branch regulations discussed in the text. Over the last several years, the FBCSI regulations under section 954 dealing with branch situations have been extensively revised by T.D. 9438 (addressing contract manufacturing and similar arrangements) and T.D. 9563 (addressing multiple branch situations).

[67]Reg. section 1.954-3(b)(1)(i)(b).

[68]Former reg. section 1.954-9T(a)(5)(iv)(A), as adopted by T.D. 8767.

[69]Reg. section 1.881-3(b)(2)(i).

regulation when statutory and pre-recharacterization rates diverge would have the odd consequence of favoring a tax reduction from, say, 30 percent to 27 percent over a tax reduction from 3 percent to zero — and detract from the conduit regulations' task of identifying tax avoidance cases.

B. Ability to Make the Advance

In determining whether an intermediate entity is a conduit, the IRS will consider whether the 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."[70] The treatment of a disregarded entity as a person for purposes of the conduit regulations arguably changes the analysis of this factor. Assume that in Example 3 in this report DutchCo is a disregarded entity and that LuxCo has sufficient cash to make the advance to DutchCo, which needs the cash to make the advances to the financed entities. Under the pre-amendment version of the conduit regulations, DutchCo was not a person, so LuxCo, its owner, made the advances to the financed entities for federal income tax purposes. Because LuxCo had the funds to make the advance without any advance to it by a financing entity (including SingBank), this factor would be positive in the analysis of whether the entity including LuxCo and its branch (DutchCo) is a conduit entity. Assuming a preponderance of positive factors, LuxCo would not be a conduit entity.

Under the conduit regulations as currently written, however, LuxCo and DutchCo are separate intermediate entities. The regulations provide that if a financing arrangement involves multiple intermediate entities, the director of field operations will determine whether each of the intermediate entities is a conduit entity using the nonexclusive factors and perhaps other factors.[71] Although, as under the previous version of the conduit regulations, LuxCo has the ability to make the advance without advances to it, DutchCo does not. Depending on the application of the other nonexclusive factors and possibly other factors, DutchCo might well be a conduit entity. The result, however, should be the same. Again, under the rule treating a recharacterized transaction as a transaction directly between the remaining parties to the financing arrangement,[72] LuxCo should (assuming a preponderance of positive factors) be one of the remaining parties, and the financing entity, if lending directly to LuxCo, would earn foreign-source interest exempt from the 30 percent tax.

If, just before the advance, the intermediate entity had on hand liquid assets at least equal to the principal amount of the advance, this would presumably be a positive factor in the analysis. Also, liquid assets owned by a wholly owned subsidiary of the intermediate entity and easily accessed would presumably constitute "available money or other property of [the intermediate entity's] own." Perhaps more problematic are plant and equipment and other illiquid assets. Are they "available" other property? Some recent case law suggests that only liquid assets are considered in determining the capitalization of a corporation for purposes of assessing whether an instrument issued by it is debt or equity.[73] Because the "ability to make an advance" factor is effectively a capitalization test, perhaps that case law should inform the analysis.

C. Time Between Advances

Another nonexclusive factor in the determination of the existence of a tax avoidance plan is the time between the transactions. According to the regulations:

> The director of field operations 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.[74]

In an example, the regulations deem a one-year lag between the first and last leg of a conduit transaction as "short" and thus evidence of a tax avoidance plan.[75]

> **Example 9:** UKCo is a publicly traded U.K. multinational that directly engages in operations in the United Kingdom and, through its subsidiaries, worldwide. To maximize liquidity and obtain the best cost of funds, UKCo typically has outstanding $10 billion of debt either issued in the capital markets or to banks. UKCo deploys the proceeds of these borrowings for general group purposes. UKCo

[70]Reg. section 1.881-3(b)(2)(ii).
[71]Reg. section 1.881-3(a)(4)(ii)(A).
[72]Reg. section 1.881-3(a)(3)(ii)(A).
[73]*See, e.g.*, *Laidlaw Transp. Inc. v. Commissioner*, T.C. Memo. 1998-232.
[74]Reg. section 1.881-3(b)(2)(iii).
[75]Reg. section 1.881-3(e), Example 17.

> and its subsidiaries also have liquid assets, derived from earnings from operations, that more than suffice to finance the $300 million in loans that it typically makes to its U.S. subsidiary. The maturity of the borrowings varies greatly, but the maturity of the advances to the U.S. subsidiary is usually one year or shorter. Although borrowings from banks and in the capital markets may be made on the same day as advances to the U.S. subsidiary, the prevailing cost of funds drives the decision to borrow, and the subsidiary's immediate needs determine the time of the advance. The terms and amounts of the borrowings and loans are unrelated.

In analyzing whether an occasional short lag (or no lag) between an advance by UKCo's lenders to it and by UKCo to its U.S. subsidiary is evidence of a tax avoidance plan, one must bear in mind that the ultimate question is whether the involvement of UKCo is for a principal purpose of tax avoidance. Based on the facts, it appears that the date of a borrowing by the U.S. subsidiary does not enter into the determination of the date of a UKCo borrowing. The period between the two borrowings will sometimes be short; if it is short, the timing is likely coincidental. That is, the group does not deliberately time the transactions to achieve a tax benefit.

One might infer that the group does not deliberately time the transactions because it does not need to. UKCo could have supplied the cash for the loans to the U.S. subsidiary without a contemporaneous cash infusion from its lenders. Thus, the same circumstance — the large amount of UKCo's and its subsidiaries' liquid assets — that tips one of the tax avoidance plan factors (that is, whether the intermediate entity could have advanced the funds without funds from the financing entity) in the group's favor, also supports the conclusion that any short lag between the borrowings is more a matter of coincidence than anything else.

Other facts supporting the coincidental nature of the timing are the different reasons for and terms of the borrowings. However, the conduit regulations do not explicitly excuse short lags between the financing entity's advance and the advance to the financed entity based on the *reason* for the short lag. Perhaps one could conclude that if evidence suggests that the shortness or lack of a time lag is coincidental, the period between the advances should be a neutral factor.

D. Other Factors

In addition to the nonexclusive factors, the conduit regulations state that the IRS may consider other, unspecified factors in determining whether a tax avoidance plan exists. One would hope, for example, that the lack of any business relationship in Example 3 between SingCo, the Singaporean subsidiary that finances export sales of Singaporean manufacturers, and DutchCo, the Dutch subsidiary that lends to U.S. customers, might constitute an unspecified factor to be taken into the mix.

The examples in the conduit regulations indeed suggest some unspecified factors. In Example 19, FP, a resident of a non-treaty country, issues debt in registered form that does not require the holder to tender Form W-8BEN. The purchasers of the debt are financial institutions and, according to the example, "there is no reason to believe that they would not furnish Forms W-8." FP lends a portion of the debt proceeds to its U.S. subsidiary. The example concludes:

> 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.

The example indicates that the existence of a reasonable assumption that the purchasers would have provided certifications establishes conclusively that there is no tax avoidance plan. Accordingly, although the determination of whether a tax avoidance plan exists depends on a consideration of all the facts and circumstances, the existence of this particular reasonable assumption seems, perhaps inexplicably, to be a superfactor of sorts.

Yet consider:

> **Example 10:** ACo is a publicly traded Argentinian multinational that directly engages in operations in Argentina and, through its subsidiaries, worldwide. ACo has a Dutch subsidiary (DutchCo) with significant operations in the Netherlands that are similar to its operations in the United States. DutchCo also acts as a European and U.S. headquarters company and finances the operations in Europe and the United States through borrowings in the capital markets, the proceeds of which it re-lends to European and U.S. affiliates. Assume that DutchCo would qualify for exemption from U.S. tax on interest paid by the U.S. affiliates under the Netherlands-U.S. tax treaty but that it could not extend its advances without the capital market borrowings. The advances to the affiliates and the borrowings are timed to occur on the same day. DutchCo's borrowings are in registered form but do not require certifications of residence by the holders. DutchCo determines, through a study performed by an accounting firm, that its debt is beneficially owned 50 percent by financial

institutions, 25 percent by Argentinian individuals, 20 percent by unspecified non-U.S. individuals, and 5 percent by unknown holders.

The example raises several questions for which there are no obvious answers:

- Is the determination of the existence of a tax avoidance plan made on an obligation-by-obligation basis or by viewing the offering as a whole? As indicated, the definition of a financing arrangement suggests the former, but Example 19 seems to support the latter. If the determination is made on an offering basis, can a favorable inference be drawn when financial institutions hold less than all the debt? If it cannot, is interest on all the debt subject to withholding in that circumstance?
- Assuming that the significance of the financial institution holders in Example 19 lies in their presumed willingness, as regulated entities, to provide the certifications, what characteristics of other holders would satisfactorily support an inference that the holders would provide the certifications? Can it be inferred that any non-U.S. individual holder would be willing to provide the certification, or would some classes of those persons (such as those concerned about their residence country acquiring tax information through an exchange of information with the United States) not be presumed to provide the certifications? Would holders resident in a country that does not exchange information be presumed to be willing to furnish a certification?
- How often must a determination of holder status be made?
- What is an acceptable method for determining holder status?

Example 20 of the conduit regulations illustrates another unspecified factor. FP, a resident of a nontreaty country, purchases raw materials and sells finished products in the United States through dollar-denominated transactions. To facilitate this business, it has maintained ''over a period of years'' an account with an unrelated U.S. bank that at all times has a balance reasonable for FP's working capital needs. Some years after FP establishes the account, the bank makes a loan to FP's U.S. subsidiary. The loan has no effect on the balance in the account. Interest on the deposit is exempt from U.S. tax,[76] but interest on a direct loan from FP to the subsidiary would not be exempt.

The example concludes that although there is a significant reduction of tax (one of the nonexclusive factors pointing toward the existence of a tax avoidance plan), the historical and continued existence of the bank account and the stability of the balance are evidence that the bank's participation in the deposit-loan financing arrangement is not part of a tax avoidance plan. The example concludes that ''in determining the presence or absence of a tax avoidance plan, all relevant facts will be taken into account.''

In one sense, it is disturbing that Example 20 in the regulations, unlike Example 19, does not conclude definitively that a tax avoidance plan is lacking. Although the facts suggest the presence of one of the nonexclusive factors (the significant reduction in tax), the other two nonexclusive factors commonly analyzed are absent. Presumably, the bank could have made the advance without the deposit, and, having been established years before the loan, the advance represented by the deposit and the loan are not synchronous. However, the example is helpful in that it suggests that the bank might not be a conduit entity even though it would not have made the loan to the subsidiary on substantially the same terms without the deposit. This is because, for an intermediate entity unrelated to both the financing entity and the financed entity to constitute a conduit, the intermediate entity's financing of the financed entity could not have been on substantially the same terms without the financing from the financing entity.[77] Thus, that the example even considers whether a tax avoidance plan exists logically must mean that the deposit favorably affects the loan terms.

Speculating, perhaps this fact explains why the example does not conclude that a tax avoidance plan is lacking. If the deposit and the loan are tied in some way, as they appear to be, the absence of two of the three adverse nonexclusive factors and the presence of an unspecified favorable factor may not be enough to conclude that there is no tax avoidance plan. What would be enough? Perhaps, to decouple the two financing transactions somewhat, the taxpayer can show that some time after the loan is made, the deposit balance drops substantially. That is, even though FP's general relationship with the bank was a precondition for the favorable loan terms, FP could not and did not funnel money through the bank to its subsidiary. Thus, the bank's participation was necessary to finance the subsidiary; it did not participate to facilitate FP's tax avoidance. Of course, in planning the transactions, one would have to anticipate that the balance

[76]Section 881(d).

[77]Reg. section 1.881-3(a)(4)(i)(C)(2).

would drop, an eventuality that may or may not occur — and so perhaps not a circumstance that could be taken into account in planning.

E. 'Significant Financing Activities'

The conduit regulations provide a rebuttable presumption that the participation of an intermediate entity in a financing arrangement is not under 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" regarding the financing transactions forming part of the financing arrangement to which it is a party.[78]

The performance of significant financing activities involves the satisfaction of several requirements:

> 1. The participation of the intermediate entity in the financing transactions produces (or reasonably can be expected to produce) efficiency savings by reducing transaction costs, overhead, and other fixed costs.[79]
>
> 2. The intermediate entity's officers and employees participate actively and materially in arranging the intermediate entity's participation in the financing transactions.[80]
>
> 3. In the country in which the intermediate entity is organized, its officers and employees manage and actively conduct the daily operations of the intermediate entity. Those operations must consist of a substantial trade or business or the supervision, administration, and financing for a substantial group of related persons. Any officer or employee of a related person cannot participate materially in these activities, other than to approve any guarantee of a financing transaction or to exercise general supervision and control over the policies of the intermediate entity.[81]
>
> 4. In the country in which the intermediate entity is organized, its officers and employees actively and continuously manage material market risks arising from the financing transactions as an integral part of (a) the management of the intermediate entity's financial and capital requirements (including management of risks of currency and interest rate fluctuations) and (b) the management of the intermediate entity's short-term investments of working capital by entering into transactions with unrelated persons. Any officer or employee of a related person cannot participate materially in these activities, other than to approve any guarantee of a financing transaction or to exercise general supervision and control over the policies of the intermediate entity.[82]

Many practitioners believe that these requirements are too onerous for the significant financing activities presumption to have any value and that the single favorable example illustrating the presumption unrealistically represents how group finance companies hedge currency and other risks. However, a typical example of a group finance company engaged in "match funding" illustrates one situation in which the presumption should apply.

> **Example 11:** Assume the same facts as in Example 4. Assume further that by centralizing bank borrowing in a single entity rather than having each operating company or each geographic or divisional group of operating companies borrow independently, FinanceCo reduces what would otherwise be the U.S. OpCos' financing costs and increases their liquidity. It also reduces duplicative finance staff. FinanceCo's managers and employees negotiate and implement FinanceCo's syndicated loan facility and its loans to the U.S. OpCos. The principal amounts and terms to maturity of FinanceCo's borrowings and loans do not always match. FinanceCo's managers and employees must invest any excess arising from any difference in short-term investments. The borrowings and loans to the subsidiaries are all U.S.-dollar denominated. Although the borrowings and loans do not bear the same interest rate, their interest rates are all pegged to the same interest rate index (such as LIBOR) and thus vary directly with one another.

It seems clear that FinanceCo should satisfy each of the first three requirements. By centralizing bank borrowing in a single entity rather than having each operating company or each geographic or divisional group of operating companies borrow independently, the group reduces what would otherwise be the OpCos' financing costs and increases their liquidity. The centralization also reduces staff. Thus, the first requirement is met in that the participation of the intermediate entity in the financing transactions produces (or reasonably can be expected to produce) efficiency savings by reducing transaction costs, overhead, and other fixed costs.

[78]Reg. section 1.881-3(b)(3)(i).
[79]Reg. section 1.881-3(b)(3)(ii)(B)(1).
[80]*Id.*
[81]Reg. section 1.881-3(b)(3)(ii)(B)(2)(i), -3(b)(3)(ii)(B)(4).
[82]Reg. section 1.881-3(b)(3)(ii)(B)(2)(ii), -3(b)(3)(ii)(B)(4).

FinanceCo's managers and employees negotiate and implement FinanceCo's syndicated loan facility and its loans to the OpCos. Thus, the second requirement should be satisfied.

In the Netherlands, FinanceCo's officers and employees exercise management over, and actively conduct, FinanceCo's borrowing, lending, and other functions. These operations consist of the financing for the entire group. Thus, the third requirement should be satisfied.

Because of a mismatch in the principal amounts of its borrowing and lending, FinanceCo frequently must bear the market risk of an inability to earn on its borrowing proceeds a return equal to the normal return it derives from on-lending to the U.S. OpCos. FinanceCo's managers and employees mitigate, but do not eliminate, that risk by investing the excess cash in short-term investments with unrelated persons. Thus, they perform functions similar to those described in requirement 4(b).

The conduit regulations provide an example of a situation that satisfies requirement 4(a) and an example of one that does not. This is the requirement that within the intermediate entity's country of organization, its officers and employees actively and continuously manage material market risks arising from the 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).

In one example, the U.S.-financed entity needs long-term financing to fund an acquisition of another U.S. company; the acquisition is scheduled to close on January 15, 1995.[83] A non-U.S. affiliate entitled to benefits under its country's treaty with the United States has a revolving credit agreement with a syndicate of banks located in a non-treaty country. On January 14, 1995, the affiliate, apparently a U.S.-dollar-functional-currency business, borrows ¥10 billion for 10 years under the revolving credit agreement. The affiliate enters into a currency swap with an unrelated bank under which it eliminates its risk of fluctuations in the yen/dollar exchange rate over the entire 10-year term of its borrowing under the credit agreement. The next day, the U.S.-financed entity borrows $100 million from the non-U.S. affiliate for 10 years. The example concludes that since the affiliate has eliminated all material market risks arising from the financing transactions through its currency swap, the presumption does not apply. The example notes, however, that if additional facts indicated that the affiliate reviews its currency swaps daily to determine whether they are the most cost-efficient way to manage its currency risk and, as a result, frequently terminates swaps in favor of entering into more cost-efficient hedging arrangements with unrelated parties, it would benefit from the presumption.

In the next example, a non-U.S. affiliate in a treaty country borrows in deutsche marks for 10 years from its non-U.S. parent, which is not located in a treaty country.[84] Two and a half months later, the non-U.S. affiliate lends in dollars to the U.S.-financed entity for a 10-year period. The non-U.S. affiliate does not enter into any long-term hedging transaction regarding these financing transactions but manages currency risk arising from the transactions daily, weekly, or quarterly by entering into forward currency contracts. The example concludes that the affiliate's participation in the financing arrangement is presumed not to be under a tax avoidance plan but that the IRS may rebut this presumption based on all the facts and circumstances. According to the example, those facts and circumstances include the short lag between the borrowing from the parent and the on-lending and the fact that the affiliate could not have advanced funds without the borrowing. (The example is probably unrealistic since a group finance company engaged in nonfunctional-currency-denominated long-term borrowings and loans would try to hedge its exposure on a long-term, not a short-term, basis.)

Both these examples lie far afield from FinanceCo's situation, since they involve long-term borrowings, as well as borrowing and on-loans that are precisely coordinated in timing and amount. Yet, the examples are instructive insofar as they illustrate that the active and regular performance of risk management by intermediate entity management and employees will (assuming all other requirements are satisfied) entitle the structure to the benefit of the rebuttable presumption, whereas the management of risk exclusively through long-term hedges will likely make the presumption unavailable.

As described above, FinanceCo's borrowings are all in U.S. dollars, and its loans to the U.S. OpCos are almost all in U.S. dollars. Thus, FinanceCo bears no currency risk on the financing arrangements that fund the U.S. OpCos. Similarly, since FinanceCo's borrowings are all at a floating rate and its loans to the U.S. OpCos are all at another floating rate that changes with the fluctuations in the rate on FinanceCo's borrowings, FinanceCo bears no interest rate risk on the financing arrangements that fund the U.S. OpCos. Thus, the requirement that the

[83]Reg. section 1.881-3(e), Example 23.

[84]*Id*. at Example 24.

intermediate entity's officers and employees actively and continuously manage material market risks arising from the loans to the U.S. OpCos as an integral part of the management of the intermediate entity's risks of currency and interest rate fluctuations is irrelevant to FinanceCo's business in relation to the U.S. OpCos. That FinanceCo lacks those risks in that business should *not* mean that it cannot meet the significant financing activities presumption, largely because it actively manages another risk.

As described above, the major risk that FinanceCo has to manage regarding the U.S. financing is a mismatch between the amounts borrowed by the U.S. borrowers and the amounts that FinanceCo has available to lend. Because of this potential mismatch, FinanceCo personnel have to constantly monitor borrowing needs and facility availability to ensure that FinanceCo minimizes its cash on hand that will earn a return less than the interest payable on the facility. Also, because of the potential mismatch, FinanceCo personnel must constantly anticipate the cash needs of all the operating companies to ensure the adequacy of the bank facility and thereby avoid the need to borrow at a cost higher than what the facility would provide. Principally on the basis of this risk management function, which is typical of finance companies of foreign-owned groups with U.S. operations, FinanceCo should be viewed as performing significant financing activities for the financing transactions forming part of the financing arrangements that include the U.S. OpCos.

The issue arises of how the active financing presumption interacts with the facts and circumstances analysis and, more specifically, how the IRS may rebut what the regulations describe as a rebuttable presumption. For example, even if FinanceCo meets the requirements of the active financing presumption, it may be unable to satisfy the general facts and circumstances test. It could not make its advances to the OpCos without the loans from the bank syndicate; the loans from the syndicate and the advances are likely synchronous at times; and, while interest on loans made by some of the banks directly to the U.S. OpCos would attract U.S. tax, FinanceCo would bear no U.S. tax under the Netherlands-U.S. treaty.

The only guidance the IRS provides on this matter lies in the examples discussed above, which state that a facts and circumstances analysis, including application of the nonexclusive factors, can rebut the presumption. However, for the rebuttable presumption to be more than just another factor, which is what the regulations purport it to be, the facts and circumstances analysis that flows from the application of the nonexclusive factors and unstated factors must logically, in order to rebut the presumption, provide a strongly negative answer for the taxpayer.

V. Conclusion

The conduit regulations have always been difficult to apply because they combine very broad principles, a large but not unbounded grant of authority to the IRS, and a dearth of non-obvious realistic examples. With the development of the U.S. treaty program and techniques for financing the U.S. operations of all multinationals — but especially foreign-based multinationals — a series of new examples addressing the problems discussed above and other ambiguities would be helpful.