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-