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

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

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

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

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

## B. Discussion of Significant Comments

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

## 1. General Approach

As described above, the final regulations adopt the general "tax avoidance" standard of the proposed regulations. Several commentators criticized the proposed regulations for setting forth new standards for the recharacterization of conduit transactions. They argued that the rulings that preceded these regulations

required matching cash flows from the financed entity to the conduit entity and from the conduit entity to the financing entity. Some commentators argued that, because in their view the regulations adopt new standards, the regulations should only be effective for transactions entered into after the enactment of section 7701(l), while others argued that the regulations should only apply to transactions entered into after the publication of the final regulations. Finally, some commentators suggested that the regulations constituted an override of our treaty obligations and might therefore be invalid.

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

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

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