with respect to payments made pursuant to the financing arrangement.

2. Discretion given to District Director

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

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

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

The final regulations do not adopt the suggestion that the district director's discretion be subject to review at the National Office level. The final regulations, like the proposed regulations, provide that the determination of whether a tax

avoidance plan exists is based on all of the facts and circumstances surrounding the intermediate entity's participation in the financing arrangement. The IRS and Treasury believe that such a determination would best be made at the local level.

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

3. Definitions

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

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

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

from treatment as financing transactions.

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

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

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

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

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