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

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

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

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

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

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

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

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

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

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

5. Presumption Regarding Significant Financing Activities

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

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

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