application of the conduit financing arrangement rules. Several commentators suggested that the final regulations eliminate this section. One commentator suggested that the rule be limited to situations where one related corporation made an equity investment in another. Another believed that the IRS and Treasury should "wait and see" whether such a rule was really necessary to prevent taxpayers from circumventing the conduit financing arrangement rules.

The IRS and Treasury believe that an anti-abuse rule is necessary to prevent the circumvention of these rules through manipulation of the definition of financing arrangement. Accordingly, $\S 1.881-3(a)(2)(i)(B)$ of the final regulations retains the related party anti-abuse rule. Moreover, the final regulations include another more 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 entity as a conduit, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent any other provision of this section. See § 1.881-3(a)(4)(ii)(B). This rule prevents a taxpayer from structuring a financing transaction with a small principal amount to reduce the amount of the recharacterized payment, and thus replaces the second half of the rule set forth in proposed regulation § 1.881–3(a)(4)(ii)(B). This rule is illustrated in § 1.881-3(e) Example 7.

8. Principal Amount

The proposed regulations provide that the principal amount of a financing transaction shall be determined on the basis of all of the facts and circumstances. Under the proposed regulations, the principal amount generally equals the amount of money, or the fair market value of other property (determined as of the time that the financing transaction is entered into), advanced in the financing transaction. The principal amount of a financing transaction is subject to adjustments, as appropriate.

Some commentators asked for clarification regarding whether adjustments would be made to the principal amount of a financing transaction to take account of amortization or depreciation. Another commentator suggested that the final regulations provide that calculations be performed in the functional currency of

the intermediate entity in order to isolate currency fluctuations.

The final regulations provide that adjustments for depreciation and amortization are made when calculating the principal amount of a leasing or licensing financing transaction. See § 1.881–3(d)(1)(ii)(A).

Although the IRS and Treasury agree that the effect of currency fluctuations should be minimized, they believe that determining the principal amount in the functional currency of the intermediate entity would not always yield the correct result. Accordingly, the final regulations eliminate currency and market fluctuations to the extent possible by providing that, when the same property has been advanced by the financing entity and received by the financed entity, the determination of the principal amount is made as of the date the last financing transaction is entered into. See § 1.881–3(d)(1)(ii)(A). An example has been added to demonstrate how this rule applies to transactions in currencies other than the U.S. dollar. See § 1.881–3(e) Example 25.

9. Correlative Adjustments

The proposed regulations do not provide for correlative adjustments in the case of the district director's recharacterization of a financing arrangement as a transaction directly between a financing entity and a financed entity.

Commentators have requested that taxpayers be allowed to make correlative adjustments if their transactions are recharacterized. Commentators generally would not, however, allow the IRS to make correlative adjustments where such adjustments would result in greater tax liability.

The final regulations, like the proposed regulations, do not provide for correlative adjustments. The IRS and Treasury agree with commentators that it is not appropriate to use regulations that are intended to prevent the avoidance of tax under section 881 to recharacterize transactions for purposes of other code sections. Accordingly, taxpayers should not be able to use these regulations to make correlative adjustments to their tax returns.

10. Recordkeeping and Reporting Requirements

The proposed regulations require corporations that would otherwise report certain information on total annual payments to related parties pursuant to sections 6038(a) and 6038A(a) to report such information on a transaction-by-transaction basis where the corporation knows or has reason to

know that such transactions are part of a financing arrangement. In addition, the proposed regulations require a financed entity or any other person to keep records relevant to determining whether such person is a party to a financing arrangement that is subject to recharacterization as part of their general recordkeeping requirements under section 6001.

Commentators criticized the reporting requirements imposed by the proposed regulation as unduly burdensome in that they would require reporting of all financing arrangements and not simply those subject to recharacterization as conduit financing arrangements. Moreover, they pointed out that, because the regulations only would require reporting of those transactions to which the financed entity is a party, the information reported would not be of significant value. The reported information would not be sufficient to allow the IRS to connect the reported financing transaction to the other financing transactions making up a financing arrangement.

The final regulations eliminate the reporting requirements provided in the proposed regulations and provide more specific guidance as to the type of records affected entities must retain. The recordkeeping requirements of § 1.881-4 have been revised to incorporate all of the information that entities would have had to report under the proposed regulations. In addition, 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. See $\S 1.881-4(c)(2)$.

11. Withholding Obligations

Under the proposed regulations, a person that is otherwise a withholding agent is required to withhold tax under section 1441 or section 1442 in accordance with the recharacterization of a financing arrangement if the person knows or has reason to know that the financing arrangement is subject to recharacterization under sections 871 or 881. Commentators asked for additional guidance regarding the application of the "know or have reason to know standard in the context of conduit financing arrangements. The final regulations include several examples regarding the circumstances in which a financed entity does and does not have