FP and BK, and between M and DS as a financing arrangement under paragraphs (a)(2)(i)(B) of this section. In such a case, BK and M would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(4)(i)(B) of this section for the authority to treat BK and M as a single intermediate entity.

Example 5. Related persons treated as a single intermediate entity. (i) On January 1, 1995, FP lends \$10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes \$10,000,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock of FS2. On January 1, 1996, FS2 lends \$10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company whose most significant asset is the stock of FS2. Throughout the period that the FP-FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP-FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP-FS loan. One of the principal purposes for the absence of a financing transaction between FS and FS2 is the avoidance of the application of this section.

(ii) The conditions of paragraph (a)(4)(i)(A) of this section would be satisfied with respect to the financing transactions between FP, FS, FS2 and DS but for the absence of a financing transaction between FS and FS2. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of an entity as a conduit, the district director may treat the financing transactions between FP and FS, and between FS2 and DS as a financing arrangement. See paragraph (a)(4)(ii)(B) of this section. In such a case, FS and FS2 would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(2)(i)(B) of this section for the authority to treat FS and FS2 as a single intermediate entity.

Example 6. Presumption with respect to unrelated financing entity. (i) FP is a corporation organized in country T that is actively engaged in a substantial manufacturing business. FP has a revolving credit facility with a syndicate of banks, none of which is related to FP and FP's subsidiaries, which provides that FP may borrow up to a maximum of \$100,000,000 at a time. The revolving credit facility provides that DS and certain other subsidiaries of FP may borrow directly from the syndicate at the same interest rates as FP, but each subsidiary is required to indemnify the syndicate banks for any withholding taxes imposed on interest payments by the country in which the subsidiary is organized. BK, a bank that is organized in country N, is the agent for the syndicate. Some of the syndicate banks are organized in country N, but others are residents of country O, a country that has an income tax treaty with the United States which allows the United States to impose a tax on interest at a maximum rate of 10

percent. It is reasonable for BK and the syndicate banks to have determined that FP will be able to meet its payment obligations on a maximum principal amount of \$100,000,000 out of the cash flow of its manufacturing business. At various times throughout 1995, FP borrows under the revolving credit facility until the outstanding principal amount reaches the maximum amount of \$100,000,000. On December 31, 1995, FP receives \$100,000,000 from a public offering of its equity. On January 1, 1996, FP pays BK \$90,000,000 to reduce the outstanding principal amount under the revolving credit facility and lends \$10,000,000 to DS. FP would have repaid the entire principal amount, and DS would have borrowed directly from the syndicate, but for the fact that DS did not want to incur the U.S. withholding tax that would have applied to payments made directly by DS to the syndicate banks.

(ii) Pursuant to paragraph (a)(3)(ii)(E)(1) of this section, even though the financing arrangement is a conduit financing arrangement (because the financing arrangement meets the standards for recharacterization in paragraph (a)(4)(i)), BK and the other syndicate banks have no section 881 liability unless they know or have reason to know that the financing arrangement is a conduit financing arrangement. Moreover, pursuant to paragraph (a)(3)(ii)(E)(2)(ii) of this section, BK and the syndicate banks are presumed not to know that the financing arrangement is a conduit financing arrangement. The syndicate banks are unrelated to both FP and DS, and FP is actively engaged in a substantial trade or business-that is, the cash flow from FP's manufacturing business is sufficient for the banks to expect that FP will be able to make the payments required under the financing transaction. See §1.1441–3(j) for the withholding obligations of the withholding agents.

Example 7. Multiple intermediate entities-special rule for related persons. (i) On January 1, 1995, FP lends \$10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes \$9,900,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock and lends \$100,000 to FS2. On January 1, 1996, FS2 lends \$10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company that has no significant assets other than the stock of FS2. Throughout the period that the FP-FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP-FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP-FS loan. One of the principal purposes for structuring the transactions between FS and FS2 as primarily a contribution of capital is to reduce the amount of the payment that would be recharacterized under paragraph (d) of this section.

(ii) Pursuant to paragraph (a)(4)(ii)(B) of this section, the district director may treat FS and FS2 as a single intermediate entity for purposes of this section since one of the principal purposes for the participation of multiple intermediate entities is to reduce the amount of the tax liability on any recharacterized payment by inserting a financing transaction with a low principal amount.

Example 8. Multiple intermediate entities. (i) On January 1, 1995, FP deposits \$1,000,000 with BK, a bank that is organized in country T and is unrelated to FP and its subsidiaries, FS and DS. On January 1, 1996, at a time when the FP-BK deposit is still outstanding, BK lends \$500,000 to BK2, a bank that is wholly-owned by BK and is organized in country T. On the same date, BK2 lends \$500,000 to FS. On July 1, 1996, FS lends \$500,000 to DS. FP pledges its deposit with BK to BK2 in support of FS obligation to repay the BK2 loan. FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan.

(ii) The conditions of paragraphs (a)(4)(i)(A) and (B) of this section are satisfied because the participation of BK, BK2 and FS in the financing arrangement reduces the tax imposed by section 881, and FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan. However, since BK and BK2 are unrelated to FP and DS, under paragraph (a)(4)(i)(C)(2) of this section, BK and BK2 will be treated as conduit entities only if BK and BK2 would not have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK.

(iii) It is presumed that BK2 would not have participated in the financing arrangement on substantially the same terms but for the BK–BK2 financing transaction because FP's pledge of an asset in support of FS' obligation to repay the BK2 loan is a guarantee within the meaning of paragraph (c)(2)(ii) of this section. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK2 will be a conduit entity.

(iv) Because BK and BK2 are related intermediate entities, the district director must determine whether one of the principal purposes for the involvement of multiple intermediate entities was to prevent characterization of an entity as a conduit entity. In making this determination, the district director may consider the fact that the involvement of two related intermediate entities prevents the presumption regarding guarantees from applying to BK. In the absence of evidence showing a business purpose for the involvement of both BK and BK2, the district director may treat BK and BK2 as a single intermediate entity for purposes of determining whether they would have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK. The presumption that applies to BK2 therefore will apply to BK. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK will be a conduit entity.

Example 9. Reduction of tax. (i) On February 1, 1995, FP issues debt to the public