intercompany payables and receivables; these payables and receivables ultimately are reduced to a single balance either due from or owing to FS and each of FP's subsidiaries. FS is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. FS must borrow any cash necessary to meet those external obligations and invests any excess cash for the benefit of the FP group. FS enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of FS are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. FS has 50 employees, including clerical and other back office personnel, located in country T. At the request of DS, on January 1, 1995, FS pays a supplier \$1,000,000 for materials delivered to DS and charges DS an open account receivable for this amount. On February 3, 1995, FS reverses the account receivable from DS to FS when DS delivers to FP goods with a value of \$1,000,000.

(ii) The accounts payable from DS to FS and from FS to other subsidiaries of FP constitute financing transactions within the meaning of paragraph (a)(2)(ii)(A)(1) of this section, and the transactions together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. FS's activities constitute significant financing activities with respect to the financing transactions even though FS did not actively and materially participate in arranging the financing transactions because the financing transactions consisted of trade receivables and trade payables that were ordinary and necessary to carry on the trades or businesses of DS and the other subsidiaries of FP Accordingly, pursuant to paragraph (b)(3)(i) of this section, FS' participation in the financing arrangement is presumed not to be pursuant to a tax avoidance plan.

Example 22. Significant financing activities-active risk management. (i) The facts are the same as in Example 21, except that, in addition to its short-term funding needs, DS needs long-term financing to fund an acquisition of another U.S. company; the acquisition is scheduled to close on January 15, 1995. FS has a revolving credit agreement with a syndicate of banks located in Country N. On January 14, 1995, FS borrows ¥10 billion for 10 years under the revolving credit agreement, paying yen LIBOR plus 50 basis points on a quarterly basis. FS enters into a currency swap with BK, an unrelated bank that is not a member of the syndicate, under which FS will pay BK ¥10 billion and will receive \$100 million on January 15, 1995; these payments will be reversed on January 15, 2004. FS will pay BK U.S. dollar LIBOR plus 50 basis points on a notional principal amount of \$100 million semi-annually and will receive yen LIBOR plus 50 basis points on a notional principal amount of ¥10 billion quarterly. Upon the closing of the acquisition on January 15, 1995, DS borrows \$100 million from FS for 10 years, paying U.S. dollar LIBOR plus 50 basis points semiannually

(ii) Although FS performs significant financing activities with respect to certain

financing transactions to which it is a party, FS does not perform significant financing activities with respect to the financing transactions between FS and the syndicate of banks and between FS and DS because FS has eliminated all material market risks arising from those financing transactions through its currency swap with BK. Accordingly, the financing arrangement does not benefit from the presumption of paragraph (b)(3)(i) of this section and the district director must determine whether the participation of FS in the financing arrangement is pursuant to a tax avoidance plan on the basis of all the facts and circumstances. However, if additional facts indicated that FS reviews its currency swaps daily to determine whether they are the most cost efficient way of managing their currency risk and, as a result, frequently terminates swaps in favor of entering into more cost efficient hedging arrangements with unrelated parties, FS would be considered to perform significant financing activities and FS' participation in the financing arrangements would not be pursuant to a tax avoidance plan.

Example 23. Significant financing activities-presumption rebutted. (i) The facts are the same as in Example 21, except that, on January 1, 1995, FP lends to FS DM 15,000,000 (worth \$10,000,000) in exchange for a 10 year note that pays interest annually at a rate of 5 percent per annum. Also, on March 15, 1995, FS lends \$10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. FS would not have had sufficient funds to make the loan to DS without the loan from FP. FS does not enter into any long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

(ii) Because FS performs significant financing activities with respect to the financing transactions between FS, DS and FP, the participation of FS in the financing arrangement is presumed not to be pursuant to a tax avoidance plan. The district director may rebut this presumption by establishing that the participation of FS is pursuant to a tax avoidance plan, based on all the facts and circumstances. The mere fact that FS is a resident of country T is not sufficient to establish the existence of a tax avoidance plan. However, the existence of a plan can be inferred from other factors in addition to the fact that FS is a resident of country T. For example, the loans are made within a short time period and FS would not have been able to make the loan to DS without the loan from

Example 24. Determination of amount of tax liability. (i) On January 1, 1996, FP makes two three-year installment loans of \$250,000 each to FS that pay interest at a rate of 9 percent per annum. The loans are self-amortizing with payments on each loan of \$7,950 per month. On the same date, FS lends \$1,000,000 to DS in exchange for a two-year note that pays interest semi-annually at a rate of 10 percent per annum, beginning on June 30, 1996. The FS-DS loan is not self-

amortizing. Assume that for the period of January 1, 1996 through June 30, 1996, the average principal amount of the financing transactions between FP and FS that comprise the financing arrangement is \$469,319. Further, assume that for the period of July 1, 1996 through December 31, 1996, the average principal amount of the financing transactions between FP and FS is \$393,632. The average principal amount of the financing transaction between FS and DS for the same periods is \$1,000,000. The district director determines that the financing transactions between FP and FS, and FS and DS, are a conduit financing arrangement.

(ii) Pursuant to paragraph (d)(1)(i) of this section, the portion of the \$50,000 interest payment made by DS to FS on June 30, 1996, that is recharacterized as a payment to FP is \$23,450 computed as follows: (\$50,000 x \$469,319/\$1,000,000) = \$23,450. The portion of the interest payment made on December 31, 1996 that is recharacterized as a payment to FP is \$19,650, computed as follows: $(\$50,000 \times \$393,632/\$1,000,000) = \$19,650.$ Furthermore, under § 1.1441-3(j), DS is liable for withholding tax at a 30 percent rate on the portion of the \$50,000 payment to FS that is recharacterized as a payment to FP, i.e., \$7,035 with respect to the June 30, 1996 payment and \$5,895 with respect to the December 31, 1996 payment.

Example 25. Determination of principal amount. (i) FP lends DM 10,000,000 to FS in exchange for a ten year note that pays interest semi-annually at a rate of 8 percent per annum. Six months later, pursuant to a tax avoidance plan, FS lends DM 5,000,000 to DS in exchange for a 10 year note that pays interest semi-annually at a rate of 10 percent per annum. At the time FP make its loan to FS, the exchange rate is DM 1.5/\$1. At the time FS makes its loan to DS the exchange rate is DM 1.4/\$1.

(ii) FP's loan to FS and FS' loan to DS are financing transactions and together constitute a financing arrangement. Furthermore, because the participation of FS reduces the tax imposed under section 881 and FS' participation is pursuant to a tax avoidance plan, the financing arrangement is a conduit financing arrangement.

(iii) Pursuant to paragraph (d)(1)(i) of this section, the amount subject to recharacterization is a fraction the numerator of which is the average principal amount advanced from FS to DS and the denominator of which is the average principal amount advanced from FP to FS. Because the property advanced in these financing transactions is the same type of fungible property, under paragraph (d)(1)(ii)(A) of this section, both are valued on the date of the last financing transaction. Accordingly, the portion of the payments of interest that is recharacterized is ((DM 5,000,000×DM 1.4/S1)/(DM 10.000.000×DM 1.4/S1) or 0.5.

(f) Effective date. This section is effective for payments made by financed entities on or after September 11, 1995. This section shall 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