Anti-Conduit Proposed Regulations Could Result in Unexpected Withholding

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Proposed Regulations would allow the Service to recharacterize the source of loans and other financing transactions and impose U.S. withholding taxes at a higher rate. While aimed at multinational groups, the rules could be applied to any controlling investor in a U.S. venture. Techniques previously used to reduce withholding might no longer work, and even result in penalties. Even loans through third parties, such as banks, could be recharacterized if granted by foreign affiliates. Foreign-controlled U.S. companies would have to disclose details of all affiliated company direct, indirect, or guaranteed loans.

Proposed Regulations[1] would recharacterize multi-party financing arrangements to prevent avoidance of withholding taxes. These "conduit" rules would have a direct impact on foreign persons with investments in U.S. entities that lease or license from foreign affiliates, or use foreign affiliates or third parties—including foreign banks—to help finance their operations. Under the Proposed Regulations (within limits discussed below), the Service could recast financing arrangements involving intermediaries to impose or increase withholding taxes on payments of interest, rents, or royalties. The Proposed Regulations would generally apply to payments made more than thirty days after publication as final Regulations, even on obligations existing before that time.[2]

The Proposed Regulations address an area of complex corporate

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[1] INTL-69-93, Oct. 11, 1994 (1994-44 IRB 24) proposing Regulations under I.R.C. §§ 871, 881, 1441, 6038, 6038A, and 7701;

[2] Prop. Reg. §§ 1.881-3(g), 1.881-4(e), 1.1441-3(j), 1.1441-7(d). Payments on existing Eurobonds to Netherlands Antilles companies are generally exempt from the Proposed Regulations.

structures. To simplify the discussion, the following abbreviations will be used for related parties:

- *DP* (domestic parent).
- *FP* (foreign parent).
- *DS* (domestic subsidiary of *FP*).
- *FS* (foreign subsidiary of either *DP* or *FP*).[3]
- *FS2* (foreign subsidiary of *FS*).

FP and *DP* are the financing entities. *DS* and *FS* are the financed entities.

Related-Party Cross-Border Loans

The Service has long been concerned with the tax-avoidance potential in cross-border loans between related parties.

> *Example. FP* (a Cayman Islands company) loans $10 million at 9.8 percent to *FS*, its otherwise inactive Netherlands Antilles subsidiary. *FS* then lends the same amount at 10 percent to U.S. affiliate *DS*. Under the U.S.-Netherlands Antilles income tax treaty, the $1 million annual interest would not be subject to U.S. withholding. The Netherlands Antilles company would pay tax on the spread, but would not pay any withholding taxes when it remitted the 9.8 percent interest to *FP*. This arrangement avoids nearly $300,000 of tax, all coming from the U.S. Similar results could be obtained in transactions involving other countries, some not requiring any interest rate spread.

The Service successfully litigated this issue in *Aiken Industries, Inc. v. Comm'r*,[4] in which a foreign non-treaty parent lent its U.S. subsidiary money in exchange for a note, then assigned the note to a subsidiary in a treaty country (Honduras) in exchange for other notes. The Tax Court held that since the Honduran subsidiary was merely a collection agent for the parent, withholding at the full rate under the Code was required. On its face, this case seemed to be limited to an assignment of notes for notes, and it still appeared that a straight loan made through the intermediary affiliate would eliminate withholding.

In its next attempt to combat this scheme, the Service released two Revenue Rulings. Revenue Ruling 84-152[5] held that a transaction similar

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[3] The discussions below involve either a domestic or foreign parent, but not both.

[4] 56 T.C. 925 (1971), *acq. on another issue*.

[5] 1984-2 C.B. 381, *modified and clarified* in Rev. Rul. 85-163, 1985-2 C.B. 349, and Rev. Rul. 89-110, 1989-2 C.B. 275, relating to application to the Netherlands Antilles.

to that in the Example above would be recharacterized as a loan directly from the Cayman company. In Revenue Ruling 84-153,[6] the issue was the use of a Netherlands Antilles finance subsidiary. In both Rulings, the intermediate parties did not participate under arm's length terms. Unfortunately for the Service, the sole theoretical rationale for these Rulings was that each loan transaction through the intermediary was a sham, although this was not explicitly stated in the Rulings.

While there was some debate as to whether the Rulings could be applied to substantive transactions, no enforcement has been reported when a sham was not involved. Some commentators have suggested that the key to these rulings and *Aiken* was whether the intermediary had "dominion and control" over the funds. As important as it may have been in the Service's prior position, the dominion and control issue has not been pursued in the Proposed Regulations or any official releases or action of the Service.

The Service also issued Revenue Ruling 87-89,[7] which attacked back-to-back loans involving an intermediary financial institution. The Ruling presented three alternative sets of facts:

1. *FP* deposits funds in an unrelated bank, which lends a lesser amount to *DS*.
2. *FP* loans money to an unrelated party, which lends a lesser amount to *DS*.
3. *DP* deposits funds in an unrelated bank, which lends a lesser amount to *FS*.

In each situation, the interest rate spread was minimal. The Ruling held that the loans should be recharacterized as a loan directly from the non-treaty parent because the intermediary would not have made the loan on substantially the same terms but for the deposit or loan of funds by the parent. This holding was based on the doctrine of substance over form.[8] It is unclear whether the Ruling would have been upheld by the courts.

In TAM 9133004, the Service addressed the use of a financing subsidiary by a foreign parent to finance U.S. acquisitions. *FP* made loans and capital contributions to *FS*, which made loans to *DS* on the same day. *FP* may have been attempting to overcome the "dominion and control" issue by using equity—payments (i.e., dividends) which are discretionary and within the control of the payor corporation—unlike

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[6] 1984-2 C.B. 1, *modified and clarified* by the Rulings in note 5, *supra*.

[7] 1987-2 C.B. 195.

[8] See, e.g., Gregory v. Helvering, 293 U.S. 465 (1935).

nondiscretionary payments on a debt obligation. The Service concluded that the activities of *FS* were not sufficient, though, and characterized the arrangement as the same sort of sham as that in the 1984 rulings.

Congress decided that this uncertainty and purported drain on revenues required action, and in 1993 authorized the Service to promulgate Regulations "recharacterizing any multi-party financing transaction as a transaction directly among any 2 or more of such parties" to prevent tax avoidance.[9] The Ways and Means Committee sought "to bolster the Treasury's ability to prevent unwarranted avoidance of tax through multi-party financial engineering, as well as to provide a mechanism for issuing additional guidance."[10] The authority granted was broader than the scope of transactions addressed in prior rulings, and specifically contemplated transactions involving debt guarantees.

The Proposed Regulations

The Proposed Regulations would permit the Service to recharacterize financing transactions in a way that may result in unexpected withholding tax obligations. Unlike the broad authority granted by the Section 482 Regulations, under which the Service may reallocate income or deductions without regard to the form of, or parties to, any actual transactions, the Proposed Regulations require that certain features be present before recharacterization is permitted. Thus, the Service would be more restrained in the number of cases in which recharacterizations could be made, though not necessarily held to a higher standard.[11] The Proposed Regulations would grant the Service authority to disregard "the participation of one or more persons in a conduit financing arrangement."[12] The Service could then determine the number of parties to, and the composition of, the financing arrangement.[13] This mechanism would require all of the following:

- The existence of a financing transaction
- Participation of an intermediate entity in that transaction
- An actual reduction of taxes on nonresidents as a result of that participation

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[9] I.R.C. § 7701(l).

[10] H.R. Rep. No. 11, 103d Cong., 1st Sess. 292 (WMCP 1993).

[11] According to the Preamble to the Proposed Regulations, the appropriate standard is "abuse of discretion," a term appearing in many court cases under I.R.C. § 482.

[12] Prop. Reg. § 1.881-3(a)(1).

[13] Prop. Reg. § 1.881-3(a)(3).

- The existence, or deemed existence, of a tax-avoidance plan
- An intermediary that either (1) is related to the borrower or lender or (2) would not have given the same loan terms to its borrower but for the terms from its lender

The absence of any of the requirements would preclude the Service from recharacterizing a set of transactions under these rules. To the extent they are valid law, however, *Aiken* and the rulings cited above could still be invoked.

The Proposed Regulations do not define "participation," but it generally should include all re-lending, leasing, and licensing activities in which an intermediate entity might engage. The Proposed Regulations also do not provide the rules for determining whether there has been a reduction of taxes under Section 871 or Section 881, but this determination should merely be a matter of comparing the U.S. tax with and without participation by the intermediate entity.

The recharacterization mechanism, like Section 482, would be available only to the Service. Taxpayers would not be permitted to disregard the form chosen for the transactions.[14]

Financing Transactions

A financing arrangement would be subject to the Proposed Regulations if it consisted of two or more "financing transactions" (discussed below) involving one or more intermediate entities between the provider of the financing (financing entity) and the receiver of the financing (financed entity).[15] While the Proposed Regulations speak in terms of entities, the definition sections use "person," so, presumably, any party to the transactions could be an individual. This conclusion is buttressed by the cross references to Section 871, which imposes a tax on nonresident individuals.

The Proposed Regulations define a financing transaction to include not only all leases, licenses, and advances of money or other property in exchange for debt, but also (under certain conditions) advances of money or property in exchange for stock or other promises to repay. Further, a financing transaction would include any transaction by which a person becomes a party to an existing financing transaction.[16]

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[14] Prop. Reg. § 1.881-3(a)(3)(ii). See, e.g., Higgins v. Smith, 308 U.S. 472 (1940).

[15] Prop. Reg. § 1.881-3(a)(2)(i).

[16] Prop. Reg. § 1.881-3(a)(2)(ii).

Stock Transactions

Issuing stock for money or property would be a financing transaction under the Proposed Regulations only if the holder of the stock (1) has one or more of the following rights or (2) is more likely than not to obtain one or more of these rights:

- To force redemption of the stock
- To force payment with respect to the stock
- To force a related party to acquire the stock or make a payment with respect to the stock

The redemption right would include a right that the holder would receive only on the occurrence of an event that is more likely than not to occur. It also would include a right of the stock's issuer to redeem the stock, if it was more likely than not that the stock would be redeemed if and when the issuer had the funds to do so. Thus, stock that carried any redemption rights and was not an inherent part of the issuer's necessary capital structure probably would not qualify.

The right to force a payment apparently would cover the normal preferential rights granted to preferred stock, notwithstanding a declaration to the contrary in the definitions portion of the Preamble.[17] It would include any right that arises when there is a default on a payment to do any of the following:

- Enforce the payment through a legal proceeding
- Cause the issuer to be liquidated
- Elect a majority of the issuer's board of directors

The right to force a payment would not include rights that arise in the ordinary course between the dates that a payment (e.g., a dividend) is declared and paid.

If the right existed only by virtue of owning a controlling interest in the issuer, and that controlling interest did not result from a default, it would not be a right to force payment under Proposed Regulation Section 1.881-3(a)(2)(ii)(B)(2). An example in the Proposed Regulations, however, is directly contrary to this statement.[18] *FP* lends $10 million to *FS*, which forms *FS2*, contributing $10 million to its capital. *FS2* lends $10 million to *DS*. The other conditions for recharacterization (tax reduction, a tax-avoidance plan, etc.) are met, so the Service is allowed to recharacterize.

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[17] See reference in Preamble to "ordinary perpetual preferred stock."

[18] Prop. Reg. § 1.881-3(f), *Example* 4.

Other Transactions

Other arrangements involving the advance of money or property might also be financing transactions if "the transferee is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value."[19] This appears to include, for example, cash advances for oil drilling in exchange for a production payment, and might include transactions in securities lending.[20] It would not apply, however, to the posting of collateral unless the intermediate entity is permitted to reduce the collateral to cash prior to default.

The Proposed Regulations would not directly attack equity investments as financing transactions. As one example clarifies, however, the use of a capital contribution in place of debt between intermediate entities could be disregarded (as in TAM 9133004), and multiple intermediate entities deemed to be one entity, if a principal purpose of the equity is to avoid application of these conduit rules.[21]

Intermediate Entities

The Proposed Regulations would not require that the intermediate entity be related to either the financing or the financed entities.[22] If the intermediate entity was not a related party, the Proposed Regulations nevertheless would apply if the entity "would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity."[23] This would be a facts-and-circumstances determination. It is presumed, however, that the intermediate entity would not have participated on substantially the same terms if the financing entity guarantees the liability. This presumption would be rebuttable only on showing "clear and convincing evidence to the contrary"—a very high standard.[24]

Under the Proposed Regulations, the Service could find that multiple intermediate entities are conduit entities subject to recharacterization.[25] Thus, if *FP* deposits funds in a foreign bank, which lends them to its

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[19] Prop. Reg. § 1.881-3(a)(2)(ii)(D).

[20] The Preamble indicates that forthcoming guidance will coordinate the Proposed Regulations with the securities lending Regulations.

[21] Prop. Reg. § 1.881-3(f), *Example* 4.

[22] Prop. Reg. § 1.881-3(f), *Example* 3.

[23] Prop. Reg. § 1.881-3(a)(4)(i)(C)(2).

[24] Prop. Reg. § 1.881-3(b).

[25] Prop. Reg. § 1.881-3(a)(4)(ii)(A).

foreign subsidiary, which lends them to *FS*, which then lends them to *DS* based on a guarantee by *FP* or a pledge of its deposits, the Service could recharacterize the entire set of transactions as between *FP* and *DS*.[26]

A special rule would apply when two or more transactions involving two or more related persons would form part of a financing transaction but for the absence of a financing transaction between the related persons. The Service could find that those related persons are a single intermediate entity if one of the principal purposes of the structure was tax avoidance.[27] For example, if *FP* lent money to *FS*, which contributed it to the capital of new *FS2*, which then lent it to *DS*, and there was a tax-avoidance purpose, the Service could recharacterize the set of transactions as between *FP* and *DS*, even if the terms of the two loans were different.[28]

Guarantees

A guarantee of financed entity debt by the financing entity would be evidence that the intermediate entity would not have entered into the transaction but for the participation of the financing entity.[29] The Proposed Regulations include a cross-reference to the definition of "guarantee" under the earnings-stripping rules.[30] Thus, a guarantee for this purpose would include not only outright guarantees, but also pledges of assets as security, compensating balances, comfort letters, and any other form of assurance of payment. The effect of this provision would be, at a minimum, to cause scrutiny of all "guaranteed" debt to determine if there was any actual reduction of withholding taxes. If so, it is likely that the financed entity would have to pay additional tax, as discussed above.

One troubling aspect of this result relates to the broad definition of guarantees under the earnings-stripping rules. For example, even a comfort letter is a guarantee for these purposes. Thus, a loan to a U.S. subsidiary of a Japanese company from a U.K. bank for which the Japanese company gave a comfort letter could result in a 15 percent tax[31] on the interest payments imposed on the U.S. company.

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[26] Prop. Reg. § 1.881-3(f), *Example* 2, which indicates that there was a tax-avoidance plan.

[27] Prop. Reg. § 1.881-3(a)(4)(ii)(B).

[28] Prop. Reg. § 1.881-3(f), *Example* 4.

[29] Prop. Reg. § 1.881-3(b).

[30] Prop. Reg. § 1.881-3(a)(2)(iv), citing I.R.C. § 163(j)(6)(D)(iii).

[31] The rate under Article 13 of the U.S.-Japan Income Tax Treaty, 2 WG&L Tax Treaties ¶ 55,525.

Tax-Avoidance Plan

For the Service to make adjustments under the Proposed Regulations, the intermediate entity's participation must be pursuant to a tax-avoidance plan. The Service merely needs to show that one of the principal purposes of a plan is tax avoidance. The plan could be written or oral, could be informal, and could be inferred to exist from all facts and circumstances. It must have been in existence, however, no later than the last date of entering into any of the transactions forming part of the arrangement.[32]

Among the factors that would be examined in determining whether a plan existed are the following:

- Whether the participation of the intermediate entity significantly reduced tax
- Whether the intermediate entity had the financial means to participate in the transaction on its own
- The time between the related transactions[33]
- The relationship of the businesses of the intermediate and financed entities[34]

This last factor is designed to prevent application of the conduit rules to normal financing of an operating subsidiary by an operating intermediate company. It would apply if the business activity in which the financed entity was engaged formed a part of, or was complementary to, a substantial trade or business conducted by the intermediate entity. Thus, if *FP* lent *FS* $100 million and *FS* lent its U.S. subsidiary, *DS*, $30 million, both *FS* and *DS* being in the widget business is evidence of no tax-avoidance plan.[35] This exception to the conduit rules should be fairly easy to meet for financing subsidiaries in an operating business.

Active Financing

A second exception to the conduit rules is provided for affiliates actively engaged in financing, though this exception might be difficult to meet in practice. It presumes that no tax-avoidance plan existed if

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[32] Prop. Reg. § 1.881-3(c)(1).

[33] The usual "old and cold" period of one full year is explicitly addressed in Prop. Reg. § 1.881-3(f), *Example* 9, as being close enough in time to indicate a tax-avoidance plan. *Cf.* the six-month period approved as "brief" for purposes of determining whether a subsequent note is merely a continuation of a prior note under Section 956 in Rev. Rul. 89-73, 1989-1 C.B. 258.

[34] Prop. Reg. § 1.881-3(c)(2).

[35] Prop. Reg. § 1.881-3(f), *Example* 10.

significant financing activities were performed by the related intermediate entity.[36] The Service could rebut this presumption by showing that a tax-avoidance plan did exist. For the financing activities of the intermediate entity to be significant, one of the following conditions must apply in relation to those activities:

- Any rents or royalties must be derived in the active conduct of a trade or business under Subpart F.[37]
- Officers and employees of the intermediate entity must perform certain active functions, described below, without the material participation of any officer or employee of a related person (other than approving any guarantees).

It is unclear whether both officers and employees would have to participate, or whether participation of either would be sufficient. In any event, they must do all of the following for the presumption to be rebutted:

1. Actively and materially participate in arranging the intermediate entity's participation in the transaction, subject to an exception for the exchange of property for trade receivables in the ordinary course of business.
2. Exercise management of the intermediate entity and execute its strategic planning and daily operations. This activity would have to consist of either a substantial trade or business or managing a substantial group of related persons.
3. Actively manage material business risks from the financing transactions as an integral part of management of financial and capital requirements and working capital investments.

The second and third requirements must be performed in the treaty country for which benefits are claimed. The Proposed Regulations provide rather detailed examples showing the acceptable and unacceptable use of cash-management subsidiaries.[38] What is clear from these examples is the extremely fact-oriented nature of determinations related to cash-management affiliates. This may make reliance on the financing affiliate exception ill-advised, except for a highly active, substantial financing affiliate bearing all of its own risks.

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[36] Prop. Reg. § 1.881-3(c)(3).

[37] Temp. Reg. §§ 1.954-2T(c) or 1.954-2T(d).

[38] Prop. Reg. § 1.881-3(f), *Examples* 12, 13, and 14, which demonstrates the effect that minute differences can have on whether a financing affiliate is sufficiently active. In particular, Example 13 points out that normal risk-hedging by the financing affiliate can prevent it from meeting the exception to the conduit rules.

Unrelated Financing Entity

Use of an unrelated banking or financing intermediate entity would reduce the risk of falling under the conduit rules. The Proposed Regulations presume that no tax-avoidance plan exists if (1) the financing entity is not related to the intermediate or financed entity and (2) the intermediate entity is engaged in a substantial trade or business. This presumption would not apply, however, if the affiliate is in a banking, insurance, or financing business primarily dealing with unrelated parties.[39]

The Service can rebut this presumption by showing a plan. So, for example, the existence of a tax-avoidance plan could result in withholding obligations in otherwise qualifying portfolio debt.[40]

An unrelated financing entity itself would not be liable for taxes resulting from recharacterization of the transactions, unless that entity knew or had reason to know of both the structure and existence of a tax-avoidance plan. When a transaction is recharacterized, the financed entity would be liable for the tax (or increase in tax), and no party would be entitled to any refund of withheld taxes except to the extent that the withholding exceeded the tax due under Section 871 or Section 881 after the recharacterization.[41]

Additional Tax

Calculating the additional tax due would present computational difficulties in all but the simplest situations. Under the Proposed Regulations, the tax would be computed by applying the appropriate tax rate to the recharacterized portion of any payments from the financed party. That portion would be determined by multiplying the whole payment by a fraction (not to exceed one) for the period covered by the payment. The numerator is the average principal balance between the conduit entity and the financing entity, and the denominator is the average principal balance between those entities. Thus, the formula for the total tax could be expressed as:

$$\text{Tax} = \text{Payment} \times \frac{\text{Avg. Principal Balance: Financing to Conduit}}{\text{Avg. Principal Balance: Conduit to Financed}}$$

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[39] Prop. Reg. §§ 1.881-3(c)(4)(i), and 1.881-3(f), *Example* 15.

[40] As defined in I.R.C. § 871(h)(3). Interest on portfolio debt is generally not subject to U.S. tax. Prop. Reg. § 1.881-3(f) *Example* 3, however, clarifies that a portfolio debt obligation can be subject to withholding tax under the conduit rules.

[41] Prop. Reg. § 1.881-3(c)(4)(ii).

For multiple-conduit entities, the numerator would be the average principal balance between the conduit entity and any party other than the financed entity. Special rules apply for determining the principal in certain situations.[42]

The tax rate is the rate that would apply to payments from the financed entity directly to the financing entity. For this purpose, the character of the payment would be determined by reference to the character of the financing transaction between the intermediate and financing entities.

Treaty Overrides

While not explicitly stated, Congressional intent in the conduit rules was to prevent treaty shopping. Thus, the Proposed Regulations are clearly meant to override treaties, which is indicated by the provision that a "treaty shall not operate to reduce the amount of tax due" on a recharacterized transaction payment.[43] This is in keeping with the traditional U.S. legal policy of preference for the rule adopted "last in time." The Preamble states, however, that the Treasury does not intend for these rules to override any of the recently negotiated limitation-on-benefits articles.[44] Rather, they are supplemental guidance under the anti-treaty shopping rules in the newer treaties. They can be so interpreted as drafted, perhaps making the override issue moot for new treaties.

Reporting and Recordkeeping

The Proposed Regulations enhance the reporting and recordkeeping rules under Sections 6038 and 6038A (on Forms 5471 and 5472), requiring additional reporting by a financed entity that is otherwise subject to reporting requirements under either Code section. The proposed rules would apply to a transaction if the financed entity knew or had reason to know that it formed part of a financing transaction, as discussed above, whether or not there is also a tax-avoidance plan. The mere existence of a guarantee by the financing entity is sufficient to require reporting.

Reporting would be required only if the person with respect to which the financed entity must report was a party to the financing arrangement.[45] Thus, all U.S. companies owing debt to foreign parties that was guaran-

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[42] Prop. Reg. §§ 1.881-3(d)(1), 1.881-3(f), *Example* 16.

[43] Prop. Reg. § 1.881-3(d)(3).

[44] See, for example, Article 27 of the new U.S.-Netherlands income tax treaty, 3 WG&L Tax Treaties ¶ 66,001.

[45] Prop. Reg. § 1.881-4(b)(1).

teed by a foreign parent would have to report payments of interest with respect to that debt on Form 5472.

Under present rules, a corporation that is at least 25 percent foreign-owned must report aggregate totals of monetary transactions with foreign related parties.[46] They also must provide "a description of any reportable transaction, or group of reportable transactions" for which there was no monetary consideration.[47] The Proposed Regulations clearly require reporting of the details of guarantees (as discussed above) of debt by related foreign parties. Advisors may want to review filings by foreign-owned corporations to ensure compliance.

Reporting would be required for each financing transaction, and transactions could not be aggregated. Specific details of the transaction and parties thereto would have to be included in attachments to Form 5471 or Form 5472.[48] Further, the "financed entity or any other person subject to the general recordkeeping requirements of section 6001" would have to keep records sufficient to demonstrate the relevant facts concerning possible recharacterization.[49]

The penalty provisions of Sections 6038 and 6038A explicitly would apply to these reporting and recordkeeping provisions. While duplicate reporting would not be required, the requirement to report each financing transaction, rather than aggregates under the regular rules, would leave this anti-duplication rule with little meaning.[50] Thus, each failure of a U.S. subsidiary to report details related to guaranteed debt could subject it to a $10,000 penalty.

Withholding Requirements

Section 1441(a) specifies that "all persons, in whatever capacity," having "control . . . or payment of any of the items of income specified" in Section 1441(b), must "deduct and withhold from such items" the tax under Sections 871, 881, 1441, and 1442. This broad definition of a "withholding agent" is further extended in the Regulations under Section 1441, which impose a tax return requirement on the withholding agent.[51]

The Proposed Regulations would expand these rules. Financed entities or "other person[s] required to withhold tax under section

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[46] Reg. § 1.6038A-2(b)(3).

[47] Reg. § 1.6038A-2(b)(4).

[48] Prop. Reg. § 1.881-4(b)(2).

[49] Prop. Reg. § 1.881-4(c).

[50] Prop. Reg. § 1.881-4(d).

[51] Reg. § 1.1441-7(a).

1441" would be required to withhold tax on any payment under a recharacterizable agreement. The requirement would apply if the payor knew or had reason to know that the financing arrangement may be subject to recharacterization. That knowledge would have to include the existence of a tax-avoidance plan.[52] Failure to withhold and pay over the tax would subject the withholding agent to a penalty of 10 percent of the non-payment, plus interest and penalty on a late payment.[53]

Partnerships and Branches

The Proposed Regulations are not limited to corporations. Partnerships operating in the United States, as well as individually owned businesses, would be affected as well. For a branch (however owned), debt could always be considered "guaranteed," since the owner of the branch would be directly liable. Thus, a branch would almost automatically be subject to additional tax if there were any actual reduction in withholding on payments effectively connected with a U.S. trade or business. Very complex calculations—which have not been addressed in the Proposed Regulations—would be needed when multiple general partners are involved.

Inadvertent Recharacterization

It is possible that financing arrangements would be conduit arrangements under the Proposed Regulations even though they were not intended to skirt withholding taxes.

> *Example. FP,* a major Japanese investor, owns operating companies in France, Australia, and the United States. *FP* often lends substantial sums to each company on revolving credit lines, but now the French and Australian subsidiaries have excess cash over the short term and the U.S. subsidiary needs cash. The group decides that the French sub should lend the U.S. sub $10 million by demand loan at 10 percent per year. The decision to use the French subsidiary was made because the withholding rate is zero under the U.S.-France treaty, but is 10 percent under the U.S.-Australian treaty. In six months, when the U.S. borrower repays the French lender plus $500,000 interest, the payment would clearly be a conduit financing arrangement under the Proposed Regulations and the U.S. borrower would have to report the transaction on Form 5472. In addition, it would have to withhold 15 percent U.S. tax (the rate under the U.S.-Japan treaty) or face penalties for failure to withhold when the

[52] Prop. Reg. § 1.1441-7(d).

[53] I.R.C. § 6656, which provides lower penalty rates for failures continuing less than fifteen days; see also I.R.C. §§ 6651, 6601.

Service recharacterizes the transactions. It seems unlikely that a local credit would be available for this payment of U.S. tax. The French government would contend either that the payment of tax was improper and not creditable, or was not the tax liability of the French company. The Japanese government would contend that *FP* did not receive the payment.

It may be necessary to examine all banking relationships. Guarantees will cause all bank financing to be suspect, and the independent actions of unrelated banks may cause problems. It is possible that planning to issue Eurobonds may itself be a tainted motive that could result in recharacterization. In Proposed Regulation Section 1.881-3(f), Example 3, *FP* deposits $1 million with an unrelated bank. A sister company of the bank purchases a new registration-required note[54] of *DS* from *DS* for $1 million. Because of the common control of the bank and the sister company, the transaction may be recharacterized if there was a tax-avoidance plan and an actual tax reduction. This could pose significant problems for many companies, both foreign-owned and domestic. Many European banks have affiliates that regularly acquire bonds of U.S. companies at original issue.

This raises the possibility that all portfolio debt issuances (such as Eurobonds) may be suspect under the Proposed Regulations. Eurobond issuances typically involve significant advance planning, a principal purpose of which is avoidance of U.S. tax on the interest—typically one of the main reasons for issuing the bonds to begin with. Is this, in itself, a tax-avoidance plan? The Proposed Regulations state that "the determination of whether the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan shall be based upon *all* the facts and circumstances relevant to *the existence of a plan and* the purposes for the participation of the intermediate entity."[55] This provision carries more weight than the statement of IRS intent in the Preamble that "the only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement, not those pertaining to the existence of the financing arrangement in general." It would be useful for the Treasury to place such wording in the final Regulations themselves.

Careful planning will be necessary to prevent inadvertent recharacterizable transactions. The mere act of proper planning may result in problems.

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[54] As defined in I.R.C. § 881(c)(2)(B)(i).

[55] Prop. Reg. § 1.881-3(c)(1), emphasis added.

Planning to Avoid Plans

One of the most effective ways to avoid recharacterization may be to avoid having a tax-avoidance plan. But how does one plan to avoid having a plan?

For a plan to be a tainted tax-avoidance plan under the Proposed Regulations, one of its principal purposes must be the reduction of U.S. tax on nonresidents. Thus, it would be permissible to plan to avoid state taxes or the taxes of other countries. Further, for the plan to meet the principal purposes test, there would have to be some actual intent to reduce U.S. tax.

A danger exists when genuine business needs require a decision whether or not to avoid tax. In the preceding example, one way to avoid recharacterization might have been to lend the money from either the Japanese investor or the Australian subsidiary. If neither company had foreign tax credit limitation problems, it would be prudent to make such a loan. Otherwise, a better course would be to find some other way of obtaining the funds. For instance, a loan from a U.S. bank and a related deposit by the French subsidiary to an unrelated bank would secure the desired withholding rate, at the cost of a small interest spread. A guarantee from the Japanese parent and a tax-avoidance plan would have no effect, because the Service likely would not deem the two unrelated banks to be a single entity. Alternatively, it may be possible to establish that the transactions with banks were part of longstanding relationships and that participation was not part of a tax-avoidance plan.

It is not clear whether use of U.S. financial intermediaries would be subject to these rules.[56] The definitions leave the possibility open, omitting references to the intermediate entity as U.S. or foreign. It can be argued that since a U.S. intermediate entity is not subject to tax under Section 871 or Section 881, while a foreign financing entity may be, use of the U.S. entity results in a reduction of the tax.

If the Proposed Regulations are made final as written, it seems likely that some IRS personnel will attempt to recharacterize arrangements involving U.S. banks. When the arrangement consists of the bare guarantee by a foreign parent of debt of its U.S. subsidiary, taxpayers should be able to raise a strong argument against the existence of a tax-avoidance plan. Even in situations similar to Proposed Regulation Section 1.881-

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[56] Informal conversations with Treasury personnel indicate that the intent of the Proposed Regulations was that U.S. financial institutions could, indeed, be "intermediate entities." This would subject the financing arrangement to the conduit rules if the other requirements, including a tax-avoidance plan, are met.

3(f), Example 2,[57] if the transactions are in the ordinary course of the bank's business and the relationship between the foreign parent (or related party) and the bank is longstanding and in the ordinary course, an argument against the existence of a tax-avoidance plan may be sustainable. Otherwise, an effort should be made to demonstrate that the institution would have participated in the transaction on substantially similar terms without the participation of the financing entity.

OID

It should be possible for short-term original issue discount (OID) instruments to avoid the conduit rules. OID is generally deemed to be interest and nonresidents are taxed on an accrual method.[58] OID on obligations payable 183 days or less from the date of original issue is excepted from this rule, however. Gain on such obligations will generally be characterized and sourced as other gains on intangible property (which may be capital or ordinary, and may or may not be effectively connected with a U.S. trade or business). As such, it likely will escape U.S. tax unless effectively connected with a U.S. trade or business.

Short-term OID, however, seems to be a one-shot arrangement. If the OID instrument is rolled over, or even if another instrument is issued within a short period after the first instrument is settled, the Service would have clear authority to disregard the nature of the transaction and recharacterize it under the Proposed Regulations.[59]

Relationship to Other Provisions

The Proposed Regulations would affect and be affected by the rules on deductibility of cross-border interest payments under Sections 163(j) and 267(a)(3). A payment to a foreign person would not be considered made for these purposes, and withholding tax would not be due, (1) until cash payment was made if the payment is interest, and (2) unless not exempted from withholding tax by a treaty and not effectively connected with a U.S. trade or business.[60] As such, the payment would not be

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[57] *Supra* note 26.

[58] I.R.C. § 871(g).

[59] See, e.g., the "twelve months is too short" rule of Prop. Reg. § 1.881-3(f), *Example* 9, and Rev. Rul. 87-89, *supra* note 7.

[60] Reg. §§ 1.267(a)-3(b)(1), 1.267(a)-3(c)(1) and 1.267(a)-3(c)(2). Certain income owed to foreign personal holding companies or controlled foreign corporations is excepted from this rule under Reg. § 1.267(a)-3(c)(4).

subject to recharacterization until paid under the constructive receipt or right of offset doctrines.[61]

Even when interest is paid to a related foreign party, it may not be currently deductible owing to earnings-stripping limitations.[62] In these situations, it might be better to restructure the financing, either to avoid the possibility of recharacterization or in a manner that ensures a deduction. Alternatively, payments that will not be currently deductible should be deferred to avoid current payment of withholding taxes.

Conclusion

Under the Proposed Regulations, foreign investors in U.S. companies would have to exercise more caution in arranging financing, including loans, licensing, and leasing. The Service could withhold or increase withholding on loans from treaty country companies if the funds originated in a country to which a higher withholding rate applies. Techniques for intercompany financing that formerly may have been effective to reduce or avoid withholding tax would not only be placed in jeopardy, but could result in substantial penalties.

The Proposed Regulations would affect transactions through intermediate entities or third parties. This includes both direct transactions, such as back-to-back loans, and indirect transactions, such as guaranteed loans. Foreign investors in U.S. companies would have to disclose most of the details of these loans. Also, foreign investors and U.S. companies with foreign affiliates should review all existing cross-border financing, whether or not with related parties, to determine reporting requirements and exposure under the proposed rules. Restructuring of some financing arrangements may be advisable if the Proposed Regulations are made final.

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[61] See, e.g., Central de Gas de Chihuahua v. Comm'r, 102 T.C. 515 (1994) (allocation under I.R.C. § 482 was a constructive payment triggering the tax under I.R.C. § 881). See also Rev. Rul. 70-251, 1970-1 C.B. 183, which held, without discussion, that when *DP* credits interest payable to its subsidiary *FS* on open account, the credit is payment.

[62] I.R.C. § 163(j) and the Regulations thereunder.