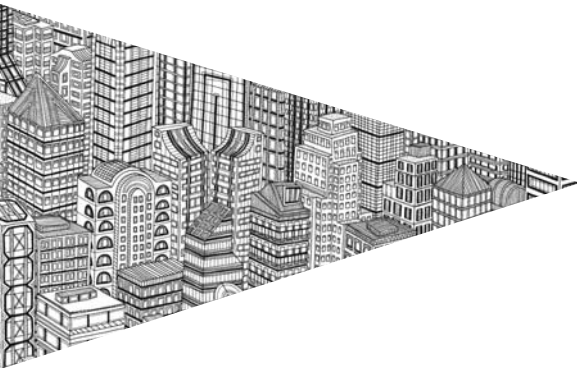


International Tax Alert



Treasury and IRS issue final regulations on disregarded entities and conduit financing

Executive summary

On 8 December 2011, Treasury and the IRS issued final regulations (TD 9562) under the conduit financing provisions of Section 7701(l) and Treas. Reg. Section 1.881-3 addressing financing arrangements that are effected through disregarded entities (DEs). The final regulations provide that a DE is a “person” for purposes of Treas. Reg. Section 1.881-3, and that transactions involving a DE will be taken into account in determining whether an entity is functioning as a conduit for purposes of avoiding Section 881 tax that would otherwise result if the conduit entity had not participated in the transaction. Final regulations adopt without change the proposed regulations issued in 2008 (see *International Tax Alert, IRS and Treasury issue proposed conduit regulations addressing disregarded entities; solicit comments on hybrid debt*, dated 23 December 2008) and apply to payments made on or after 9 December 2011.

The final regulations do not address hybrid instruments (instruments that are treated as debt for foreign tax law purposes but not for US federal tax purposes), but the preamble states that Treasury and the IRS continue to study these and other equity instruments in the context of conduit financing arrangements.

Detailed discussion

Treas. Reg. Section 1.881-3 generally allows the IRS to disregard the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities, and to recharacterize

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the financing arrangement as a transaction directly between the remaining parties for purposes of imposing tax under Sections 871, 881, 1441 and 1442.

An intermediate entity is a conduit entity if its participation in a financing arrangement reduces the Section 881 tax due on a transaction, its participation is pursuant to a tax avoidance plan, and it is related to other entities in the transaction or would not have participated in the arrangement on the same terms but for the participation of the other entities in the transaction. A "financing arrangement" is defined in Treas. Reg. Section 1.881-3(a)(2)(i)(A) as a series of transactions where one person advances money or property, or grants rights to use property, to another person, the advance and receipt are effected through one or more other persons (intermediate entities), and there are financing

transactions linking each of the parties to the transaction.

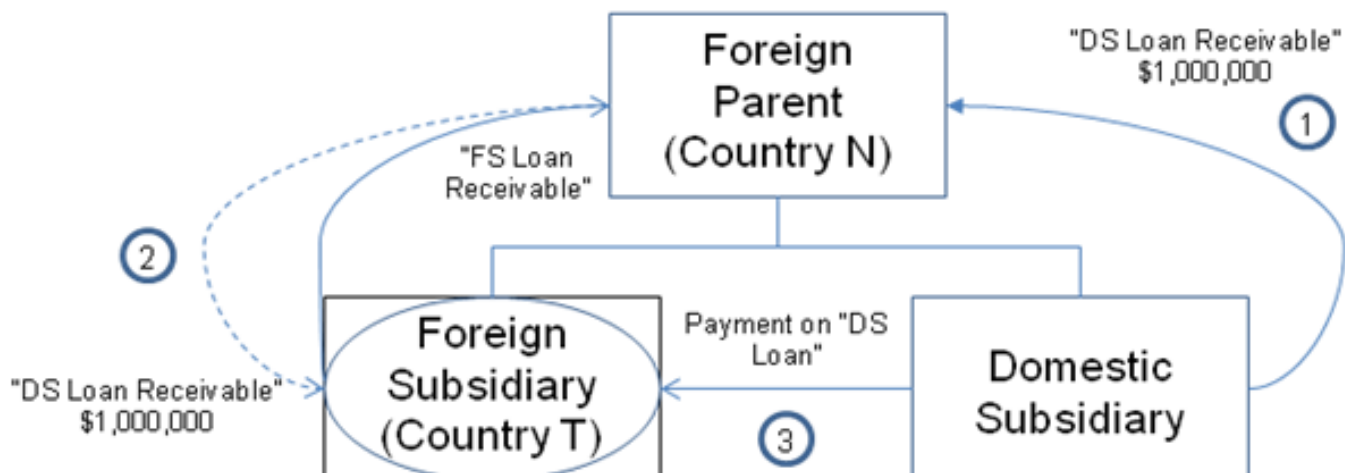
Prior to the issuance of the proposed regulations, some taxpayers had taken the position that a DE is not considered a "person" under Section 7701(l) or Treas. Reg. Section 1.881-3, and, as such, it could not be considered a party to any of the transactions that comprise a multi-party financing arrangement. Under this view, arrangements involving DEs could avoid characterization as "financing arrangements" and would not be subject to recasting under Treas. Reg. Section 1.881-3.

The final regulations provide that the term "person" includes a DE for purposes of the conduit regulations and provide the following example (which was also included in the proposed regulations):

Foreign Parent, a corporation organized in country N, owns all of the stock of Foreign Subsidiary, a corporation

organized in country T, and Domestic Subsidiary, a corporation organized in the United States. Foreign Subsidiary is disregarded as an entity separate from its owner, Foreign Parent, under Treas. Reg. Section 301.7701-3. Country T, but not country N, has an income tax treaty with the United State which exempts interest, rents and royalties from source-country taxation.

On 1 January, Year 1, Foreign Parent lends \$1,000,000 to Domestic Subsidiary in exchange for a note issued by Domestic Subsidiary ("DS Note Receivable"). On 1 January, Year 2, Foreign Parent assigns the DS Note Receivable to Foreign Subsidiary in exchange for a note issued by Foreign Subsidiary (FS Loan Receivable). After receiving notice of the assignment, Domestic Subsidiary remits payments due under the note to Foreign Subsidiary.



Under paragraph Section 1.881-3(a)(2)(i)(C), Foreign Subsidiary is a person and, therefore, may itself be an intermediate entity that is linked by financing transactions to other persons in a financing arrangement. The DS note held by Foreign Subsidiary and the FS note held by Foreign Parent are financing transactions within the meaning of paragraph Section 1.881-3 (a)(2)(ii) and together constitute a financing arrangement within the meaning of paragraph Section 1.881-3 (a)(2)(i).

Implications

When the proposed regulations on DEs and the conduit regulations were issued in 2008, Treasury and the

IRS made clear that they viewed the proposed regulation as a clarification of the current rules rather than a change. Taxpayers have thus been on notice that any structures involving DEs could come within the ambit of the conduit financing provisions. Importantly, the preamble states that “no inference should be drawn from any provision of these final regulations as to the treatment of financing transactions entered into with DEs before the effective date of these final regulations or involving hybrid instruments,” meaning that transactions involving payments to DEs prior to the date of the final regulations may be subject to recharacterization by the

IRS under the Section 881 rules. Final regulations apply to payments made on or after 9 December 2011, therefore taxpayers will need to consider the impact of these regulations before making any year end payments. The preamble also states that Treasury and the IRS continue to study hybrid instruments and solicit comments on their treatment in financing transactions. Practitioners should discuss with affected clients whether it would be beneficial to participate in the comment process as the government considers the appropriate treatment of hybrid instruments in the context of the conduit rules.

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