REPORT #814

TAX SECTION

New York State Bar Association

Report on Proposed Regulations issued under

Section 7701(l) of the Internal Revenue Code

December 16, 1994

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December 16, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Conduit Financing Regulations
INTL-0064-93

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a Report by the New York State Bar Association Tax Section commenting on the proposed regulations under Code Section 7701(1) relating to conduit financing arrangements. The Report states that the regulations provide generally clear and reasonable guidance, are of appropriate length, and appropriately use examples to illustrate general principles.

The Report makes a number of additional comments on the regulations, including the following:

1. We support the basic approach of the regulations of applying Section 7701(1) only to specifically enumerated Code sections.

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Howard O. Colgan, Charles L. Kades, Carter T. Louthan, Samuel Brodsky, Thomas C. Plowden-Wardlaw, Edwin M. Jones, Hon. Hugh R. Jones, Peter Miller, John W. Fager, John E. Morrissey Jr., Charles E. Heming, Richard H. Appert, Ralph O. Winger, Hewitt A. Conway, Martin D. Ginsburg, Peter L. Faber, Hon. Renato Beghe, Alfred D. Youngwood, Gordon D. Henderson, David Sachs, J. Roger Mentz, Willard B. Taylor, Richard J. Hiegel, Dale S. Collinson, Richard G. Cohen, Donald Schapiro, Herbert L. Camp, William L. Burke, Arthur A. Feder, James M. Peaslee, John A. Corry, Peter C. Canellos

2. We do not disagree with the exclusion of common stock and perpetual preferred stock from the definition of a "financing transaction" subject to the regulations. However, we note that this exclusion (and another exclusion for the posting of collateral) draw lines between transactions that in many cases will be entirely formal.

3. Additional guidance should be provided in a number of situations, including leases and licenses, multiple intermediaries, the requirements for a tax avoidance plan, the exceptions for related and unrelated intermediaries, and withholding obligations of unrelated intermediaries.

4. The proposed effective date (all payments made at least 30 days after adoption of final regulations) is a harsh rule. The regulations should apply only to transactions entered into after the regulations were proposed. Alternatively, for transactions entered into before the proposal date, the regulations should not apply for some specified period of years (although such transactions should be subject to common law rules in the interim).

5. While we do not question the authority for the regulations or their conformity with the intent of Congress, we are concerned that the regulations, in not deferring to tax treaties, will be perceived as in effect overriding tax treaties.

Please let me know if we can be of further help in the development of these regulations.

Very truly yours,

Michael L. Schler
Chair, Tax Section

December 16, 1994

Report on Proposed Regulations issued under
Section 7701(1) of the Internal Revenue Code

This report, prepared by an *ad hoc* committee of the Tax Section of the New York State Bar Association,[1]/ comments on regulations (hereafter, the "Proposed Regulations") proposed on October 14, 1994 under Section 7701(1) and certain related provisions of the Internal Revenue Code.

Section 7701(1) of the Internal Revenue Code authorizes the issuance of regulations that may recharacterize any "multiple-party financing transaction" as directly among any two or more parties if recharacterization is appropriate to prevent tax avoidance.

We previously submitted comments on the issues that might be addressed by regulations to be issued under Section 7701(1).[2]/ Many of these are reflected in the Proposed Regulations, and we appreciate the Internal Revenue Service's receptivity to our suggestions.

We believe that the Proposed Regulations provide generally clear and reasonable guidance with respect to the circumstances in which Section 7701 (1) will be applied, and we think that the length of the Proposed Regulations, and their use

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[1]/ Consisting of John A. Corry, John J. Creed, Michael Hirschfeld, Deborah Jacobs, Stuart Leblang, Jonathan T. Lebow, Richard Loengard, Pinchas Mendelson, Michael Schler, Philip H. Spector and Willard B. Taylor, who was the principal draftsman. Helpful comments were received from Neil Auerbach, Carolyn Lee, Steve Millman, Richard Reinhold and Ralph Winger.

[2]/ Report of January 24, 1994 with respect to issues to be addressed by regulations under Sections 163 (j) and 7701 (1)

of examples to illustrate general principles, is entirely appropriate under the circumstances.

Under the Proposed Regulations, the Internal Revenue Service may disregard an intermediary (a so-called “conduit entity”) if (i) there is a “financing arrangement”, defined as an arrangement consisting of two or more loans or other “financing transactions”; (ii) the participation of the intermediary reduces the U.S. tax that would be imposed under Section 871 or 881 of the Internal Revenue Code; (iii) the participation of the intermediary is pursuant to a tax avoidance plan; and (iv) if the intermediary is unrelated to the financing and the financed entity, the intermediary would not have participated in the arrangement on substantially the same terms but for the participation of the financing entity. According to the Notice of Proposed Rulemaking, the exercise of the authority given to the Internal Revenue Service by the Proposed Regulations in such a case is subject to an “abuse of discretion” standard, presumably similar (although this is not stated) to the standard for reviewing determinations of the Internal Revenue Service under Section 482 of the Internal Revenue Code.

The Proposed Regulations are in substance limited to the U.S. withholding tax on interest, dividends, royalties and other items of U.S. source income, and apply to payments that are made after the date that is 3 0 days from their adoption as final regulations, regardless of when the underlying loan or other transaction was entered into. They apply without regard to whether the foreign intermediary that receives the interest, royalties or other income is entitled to the benefits of a tax treaty.

Our comments on the Proposed Regulations are set out below.

Comments on the Proposed Regulations.

[1] Scope of the Proposed Regulations. Although Section 7701(l) authorizes the issuance of regulations to prevent avoidance of any provision of the Internal Revenue Code (more precisely, "any tax imposed by" Title 26), the Proposed Regulations are limited to the U.S. withholding tax, i.e., the tax imposed on nonresident aliens and foreign corporations by Sections 871 and 881 which are ordinarily collected by withholding under Sections 1441 and 1442. We support the general approach of applying Section 7701(l) only to specifically enumerated sections of the Internal Revenue Code. The standards for the application of Section 7701(l) may vary from section to section. In addition, there are "common law" challenges to conduit arrangements, and regulations under Section 7701(l) should be used for this purpose only where there is a specific need to do so. We assume, however, that the approach of the Proposed Regulations may in due course be extended to other specified sections of the Internal Revenue Code -- specifically, in the final regulations with respect to the so-called earnings stripping rules under Section 163 (j). If so extended, account should be taken of any differences in context. Conduit treatment for purposes of Sections 163 (j) or Section 956, for example, will generally not involve any concerns about "overriding" tax treaties; likewise, both of those sections have special rules for guarantees.

[2] Definition of a financing arrangement and a financing transaction. For the Internal Revenue Service to have the authority to treat an intermediary as a conduit entity there

must be a “financing arrangement”, defined as an arrangement consisting of two or more “financing transactions”.[3]/

A “financing transaction” consists of a loan, lease, license or the acquisition of stock which by its terms entitles the holder to be redeemed or taken out. It does not include a guarantee, the provision of collateral (unless the collateral can be reduced to cash prior to a default) or, generally, an investment in perpetual preferred or common stock, although the Notice of Proposed Rulemaking indicates that the Proposed Regulations might be extended to cover both investments in common or perpetual preferred stock and guarantees if the Internal Revenue Service determines that taxpayers are using these exclusions to avoid U.S. withholding tax.[4]/ Thus, an investment in the common stock of a foreign corporation which then loans the proceeds to a U.S. corporation is not a “financing arrangement”, since there is only one “financing transaction”.

This threshold definition -- i.e., the requirement of at least two financing transactions -- for the application of Section 7701(l) is generally consistent with what we had recommended in our prior report. For the reasons set out there, we also believe it is appropriate to exclude guarantees from the definition of a financing transaction.

[a] Common and perpetual preferred stock. The practical difficulty of treating an intermediary as a conduit entity in cases where it is not entitled to receive and/ or required to pay

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[3]/ Prop. Regs. § 1.881-3(a) (4).

[4]/ And Prop. Regs. § 1.881-3 (a) (4) (ii) (B) includes a rule intended to prevent this exclusion from being manipulated by the use of multiple intermediaries. See also Examples (3), (4) and (5) of Prop. Regs. § 1.881-3(f).

dividends provides one justification for excluding investments in common stock. In addition, limitation on benefits articles of tax treaties will limit the extent to which the Proposed Regulations can be avoided by investments in common or perpetual preferred stock. While not disagreeing with the exclusion of these investments, therefore, it is fair to point out that the exclusion draws a line between transactions that in many cases will be entirely formal. If the intermediary is a controlled subsidiary of the financing party, whether the subsidiary is capitalized with common or perpetual preferred stock or debt will have little effect on the financing party's practical rights to seek a return of its investment. Likewise, the exclusion of the posting of collateral from the definition of a financing transaction draws a sharp line between a case where the financing party advances cash and advances property, particularly in cases where the property consists of cash- equivalents, such as U.S. Government obligations. The concerns that we expressed in our prior report about guarantees (the treatment of cases where a foreign parent guarantees third-party debt of its U.S. subsidiary or a U.S. parent guarantees third-party debt of its foreign subsidiary) do not extend to the posting of collateral.

Assuming that the final regulations continue the exclusion for investments in common and perpetual preferred stock, the language should be clarified. While the Notice of Proposed Rulemaking clearly states the Service's intention to exclude investments in common and perpetual preferred stock, the language of the Proposed Regulations is less clear. Thus, Prop. Regs. § 1.881-3(a) (2) (ii) (B) (1) provides that a financing transaction includes an advance of money for equity if " [a]s of the issue date, the holder has the right...to cause the issuer to redeem the stock", and it might be questioned whether an advance of money for equity representing control of the issuer did not

give the financing party that right. This language should be conformed to that in Prop. Regs. § 1.881-3(a) (2) (ii) (B) (2), relating to rights to cause the issuer to make payments, which expressly excludes "a right derived from ownership of a controlling interest in the issuer in cases where the control does not arise from a default or similar contingency under the [terms of the] instrument".

[b] Leases or licenses. A financing transaction also includes "[a]ny" lease or license. Wholly apart from the difficulty of determining the "principal amount" of such a financing transaction, which under Prop. Regs. § 1.881- 3(d) (1), is central to the determination of how much tax should have been withheld, it is unclear whether every lease or license should be regarded as a financing transaction. It is understandable that conduit treatment may be appropriate if A licenses or leases property to B which licenses or leases the same property to C, but (assuming that the transactions are at arm's length) is there always a financing if A licenses or leases property to B which lends money to C or vice versa or if the property licensed or leased to C is different from the property licensed or leased to B? These seem to us to present definitional issues. One possibility would be to exclude from the definition of a financing transaction any lease or license to an intermediary of non-fungible property that was retained and used by the intermediary in its business. Thus, a lease or license of property by A to B would not be a financing transaction if B used that property in its business and did not lease or license it to C, notwithstanding that B may have advanced money to C in financing transactions or licensed or leased other property. Another approach, discussed below, would be to provide in Prop. Regs. § 1.881-3 (c) that, where a financing arrangement consists of dissimilar financing transactions, this is a factor which

supports the conclusion that the intermediary's participation was not pursuant to a tax avoidance plan.

[c] Multiple intermediaries. Prop. Regs. § 1.881-3(a)(4)(ii)(B) permits the Internal Revenue Service to treat related entities as a single intermediary if there would be a financing arrangement but for the absence of a financing transaction between the related parties. Thus, as illustrated by an example, if a foreign parent lends to its foreign subsidiary, B, and B invests in the common stock of its foreign subsidiary, C, which loans to a U.S. subsidiary, D, the Internal Revenue Service may treat B and C as a single intermediate entity, resulting in conduit treatment if the participation of that single entity was pursuant to a tax avoidance plan[5].

This rule is an appropriate limitation on the exclusion of common and perpetual preferred stock from the definition of a financing transaction, but it may be interpreted to go too far in some cases. Suppose, for example, that a foreign corporation, A, borrows from banks in countries that do not have tax treaties that eliminate U.S. withholding on U.S. source interest, that A has foreign subsidiaries in treaty countries and that those foreign subsidiaries lend from time to time to A's U.S. subsidiaries -- the multiple intermediary rule would possibly treat A and its foreign subsidiaries as a single entity and a conduit for a loan from the foreign banks to the U.S. subsidiary. It is unclear how the presumption of no tax avoidance plan that applies to certain related intermediaries[6]/ would apply in such a case. It would be useful to have an example which both illustrated the application of the presumption in such a case and

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[5]/ Example (4) of Prop. Regs. § 1.881-3 (f).

[6]/ See Prop. Regs. § 1.881-3(c)(3)(i).

concluded that the participation of A and its foreign subsidiaries was not pursuant to a tax avoidance plan if there was no reason to believe that the arrangement was designed to circumvent the exclusion from the definition of portfolio interest of certain interest paid to banks.

[3] Reduction in tax. If there is a financing arrangement, the first requirement for conduit treatment is that the participation of the intermediate entity in the financing arrangement reduce the U.S. withholding tax, i.e., the tax imposed by Sections 871 and 881 which is ordinarily collected by withholding under Sections 1441 and 1442.

We assume that the tax reduction test focuses on substantive tax reduction, not procedural or technical noncompliance.

Suppose, for example, that a foreign subsidiary of a U.S. or foreign corporation borrows from unrelated foreign persons and also lends to the U.S. corporation and that interest paid by the U.S. corporation is exempt from U.S. withholding tax under a tax treaty. This is a commonplace transaction. It should not be asserted that there has been a reduction in tax within the meaning of the Proposed Regulations if the hypothetical withholding tax liability on direct payments from the U.S. corporation to the unrelated foreign lenders would be solely attributable to the failure of the lenders to provide Forms W-8 or Forms 1001 or simply because debt obligations issued by the foreign subsidiary satisfy Regs. § 1.163-5 (c) (2) (i) (C) (i.e., the so-called TEFRA C rules) but not Regs. § 1.163-5 (c) (2) (i) (D) (i.e., the so-called TEFRA D rules). If there are concerns about compliance with the procedural rules for eliminating or reducing the U.S. withholding tax on interest, these should be

dealt with by changes to those rules, not by regulations under Section 7701 (1).

Likewise, there should be no reduction in tax because the financing arrangement results simply in a short-term delay in the payment of U.S. withholding tax -- for example, where the intermediary is a U.S. partnership and interest is subject to U.S. withholding tax at a later point in time than if it had been paid directly to the foreign partners.

[4] Tax avoidance plan. The second requirement for conduit treatment is that the participation of the intermediary be pursuant to a tax avoidance plan. This is to be determined under all of the facts and circumstances, several of which are set out in a non-exclusive list in the Proposed Regulations. In the case of a related intermediary, there is a rebuttable presumption of no-participation-pursuant-to-a- tax-avoidance-plan if the intermediary "performs significant financing activities with respect to the financing trans-actions" that make up the financing arrangement; in a case where the intermediary is unrelated to the financing entity, there is a rebuttable presumption of no-participation- pursuant-to-a-tax-avoidance-plan if the intermediate entity is actively engaged in a substantial trade or business (other than the business of making or managing investments, except pursuant to a banking, insurance, financing or like business the income from which is predominantly earned from unrelated persons).

Our suggestions are as follows:

-- The Proposed Regulations do not capture the spirit of the statements in the Notice of Proposed Rulemaking that "the only relevant purposes are those pertaining to the participation

of the intermediate entity in the financing arrangement” and that the pursuant-to-a-tax-avoidance-plan requirement “ensures that [the Proposed Regulations] apply only to transactions that are related to each other through .the taxpayer's intention to secure, in an artificial manner, exemptions or reductions of withholding tax that would not otherwise be available given the economic substance of its transactions”. Given that tax avoidance need only be “a” principal purpose of the intermediary's participation, some of what is set out in the Notice of Proposed Rulemaking might usefully be included in the final regulations.

-- The first of the factors mentioned in the Proposed Regulations is whether the participation of the intermediary “significantly” reduces the U.S. withholding tax. This adds nothing to requirement of Prop. Regs. § 1.881- 3(a)(4)(A) except for the word “significantly” and, without any definition of “significance”, is of very little use. Some indication of what*'the Internal Revenue Service regards as “significant” in this context would be helpful.

-- It would also be useful to clarify the second of the factors that is mentioned, i.e., how the ability of the intermediary to make the advance of money or other property without the advance of the money or other property from the financing party is to be determined. In the case of a loan, is there an inability to make the advance if, simply looking at the intermediary's balance sheet, it does not meet the “not-sufficiently-liquid” test of Rev. Rul. 84-152 or can an intermediary “pass” the factor by establishing that it could have borrowed sufficient funds from others?

-- It would be useful if there was more elaboration of the specific facts and circumstances that may be taken into

account in determining whether there is a tax avoidance plan. Other than a "significant" reduction in tax, the factors mentioned are the length of time between the financing transactions, the ability of the intermediary to finance the financed party without the transaction with the financing party and, in the case where the intermediary is related to the financed entity, whether the two entities enter into the transaction to finance a business actively engaged in by the financed entity. With respect to the first of these factors, two examples indicate that one year is not "too long".[7]

Other factors that might usefully be mentioned as supporting conduit treatment (if not necessarily establishing whether there is a tax avoidance plan) are similarity in terms, amounts and nature of the financing transactions that make up the financing arrangement. Thus, close similarity in terms and proximity in time, while not establishing the presence of a tax avoidance plan, may tend to indicate that there was such a plan. With respect to the nature of the financing transactions, a lease of property by A to B and a loan of cash by B to C is much less likely to be appropriately recharacterized than loans by A to B and by B to C, particularly if the amount and terms are similar. We have suggested above that it may be appropriate simply to exclude licenses and leases from the definition of a financing transaction in cases where the property that is licensed or leased is used in the intermediary's business and not licensed or leased to the financed party; if this recommendation is not adopted, the fact that the property is not licensed or leased should at least be taken as evidence that there was no tax avoidance plan. Other factors (e.g., whether a lease is an "operating" lease or whether the use of the intermediary enhances

[7] Examples (9) and (2) of Prop. Regs. § 1.881-3 (f).

copyright or patent protection) might be mentioned and, possibly, illustrated by example.

It might also be made clear that costs other than U.S. taxes are to be considered. Thus, the absence of a tax avoidance purpose could be established by showing that, overall, taking into account foreign as well as U.S. tax, there is no significant savings from the participation of the intermediary in the arrangement -- for example, there would be no tax avoidance plan if the U.S. withholding tax that would otherwise have been paid would in any event simply have been a foreign tax credit against the intermediary's tax liability. For this purpose, the reasonable “spread” of an intermediary (at least if unrelated) should be considered a “cost” in evaluating whether there is an overall savings to the financing and financed party from the participation of the intermediary.

[a] Related intermediary presumption. The presumption of no participation pursuant to a tax avoidance plan that is available when the intermediary is related and “performs significant financing activities with respect to the financing transactions” is useful, but the reasoning of two of the three examples that illustrate the rule is unclear. In reaching the ' conclusion that a foreign subsidiary is entitled to the presumption with respect to some of its transactions but not with respect to a medium term loan to a U.S. sister corporation, Example (13) gives the impression that the presumption would have applied with respect to the medium term loan had the foreign subsidiary not eliminated, through a swap, the currency risk involved in borrowing Yen and lending U.S. Dollars. The reference to currency risks in Example (14) reinforces the impression. It does not seem to us that currency risks should be determinative.

[5] Unrelated intermediaries. If the intermediary is not related to the financing or financed entity, the intermediary will not be treated as a conduit entity unless it 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. It is presumed that this is the case if the financing entity guarantees the liability of the financed entity to the intermediary. The presumption may be rebutted by clear and convincing evidence.

But for the addition of the word "substantially" and the broad definition of a guarantee, this is substantively the same rule that the Service announced in Rev. Rul. 87-89. We offer the following suggestions:

-- There is no elaboration on the circumstances in which terms will not be regarded as "substantially" the same. We suggested in our prior report that measurement under the proposed Section 1001 Regulations might be a possibility and we continue to think that this should be considered. Thus, only a meaningful difference in the substantive terms that resulted from the transaction between the intermediate entity and the financing entity would be enough to lead to the conclusion that the intermediary would not have participated on substantially the same terms and this requirement for conduit treatment is met.

-- A guarantee is defined by reference to Section 163 (j) and its legislative history. It thus picks up any arrangement, whether conditional or unconditional, that assures payment, including "an arrangement reflected in a 'comfort letter', regardless [of] whether the arrangement gives rise to a legally enforceable obligation". In our prior report, we commented on the need for regulations that would define a

“guarantee” for purposes of Section 163 (j). The use of the same term for purposes of the presumption in the Proposed Regulations underscores the importance of having such regulations.

We note that the would-not-have-participated-on-substantially-the-same-terms test looks to changes in the terms caused by any “financing transaction” between the intermediary and the financing entity. A guarantee by the financing entity of the financing transaction between the intermediary and the financed entity is not a financing transaction. Thus, while a guarantee creates a presumption that the transaction flunks the would-not-have-participated- on-substantially-the-same-terms test, it is ultimately irrelevant to the issue -- a difference in the terms of the transaction with the financed entity has to be attributable to something other than the guarantee, such as a loan from the financing party to the intermediary. Indeed, the presence of a guarantee would seem to make it more likely that the intermediary would have participated in the financing arrangement on substantially the same terms in the absence of the financing transaction between the financing entity and the intermediary. This should be clarified.

[6] Amount of tax liability. If a financing arrangement is recharacterized, the amount of the withholding tax liability is determined by treating a portion of each of the payments made by the financed party as made directly to the financing entity. The portion is equal to the ratio, but not more than 1-to-1, of the average principal amount received by the conduit entity from the financing entity to the average principal amount received from the conduit entity by the financed entity. As we recommended in our prior report, this has the effect of determining whether the payments on the recharacterized transaction are interest,

dividends or royalties by looking at the character of the transaction between the conduit entity and the financed entity.

The ratio set out in the Proposed Regulations generally works well where both financing transactions are loans or otherwise have an identifiable issue price -- if, for example, A lends $100 to B and B lends $150 to C, 2/3rd of each of C's payments would be treated as made to A if the transaction was recharacterized. It does mean, however, that B's “spread”, if any, is potentially subject to withholding tax, although not received by A -- if the principal amounts of the two financing transactions were identical, but the loan to C was at 10% and the loan from A at 8%, the withholding would be on the interest of 10%. We question whether that was intended.

In cases where the financing transactions have no identifiable issue price (e.g., in the case of a lease or license of property), the Proposed Regulations provide that the principal amount is the fair market value of the property advanced. One example illustrates such a transaction. One obvious difficulty is determining fair market value -- the example skirts this issue by assuming that there is no change in value between the date of the license-in and the license- out or thereafter. Another issue is how the principal amount of a license or lease is to be adjusted. In the case of a loan, the ratio used to determined the amount of the recharacterized payments is based on the average principal amount of the financing transactions for the period in which the payments are made --in the case of a license or lease, it is based on the fair market value at the inception of the transaction “subject to adjustments, as appropriate”. Suppose, for example, that property with an economic life of 5 years and an initial value of $100 is leased to an intermediary and

property with the same value and an economic life of 10 years is leased by the intermediary --is the ratio a constant 1-to-l?

[7] Effective date. The Proposed Regulations will apply to payments made 30 days after their adoption as final regulations, without regard to when the underlying transaction was entered into. This is a harsh rule --we had recommended that proposed regulations apply only to transactions entered into on or after the date the regulations were proposed, which would have been consistent with the Service's position with respect to Rev. Ruls. 84-152 and 84-153 and seemed to us to strike a fair balance between the concerns of the Service and the importance of not upsetting settled expectations.[8]/ Alternatively, payments in transactions entered into on or before the date the regulations were proposed might be “grandfathered” for a period of years. Any transaction that was so grandfathered would, of course, be subject to the rules that applied before the enactment of Section 7701(1).

[8] Relationship with tax treaties. The Proposed Regulations apply without regard to whether the intermediary is or is not entitled to the benefits of a tax treaty -- thus, for example, a Netherlands corporation could be disregarded (i.e., treated as a conduit entity), notwithstanding that, after the application of Article 26 of the U.S.-Netherlands tax treaty, it was determined to be entitled to the benefits of that treaty. In our prior report, we took no position on the relationship between Section 7701(1) and tax treaties, although we suggested a number of ways in which regulations under Section 7701(1) might accommodate tax treaties that included up-to-date limitation on

[8]/ We assume that prior published Internal Revenue Service rulings with respect to conduit arrangements will be modified in so far as they relate to withholding taxes upon the adoption of the Proposed Regulations as final regulations.

benefits provisions, such as Article 26 of the U.S.-Netherlands tax treaty. Without questioning the authority of the Internal Revenue Service to adopt the Proposed Regulations as final Regulations, or the intent of Congress in enacting Section 7701 (1), we continue to be concerned that, in not deferring to such treaties, the Proposed Regulations will be perceived as, in effect, overriding tax treaties. In that connection, it is not accurate to describe the Proposed Regulations as "reflect[ing] common law substance over form principles as applied to conduit financing arrangements" -- they go beyond what any court has held and, in so far as they apply to financing arrangements involving leases, licenses and some forms of equity, anything that the Internal Revenue Service had ruled on publicly prior to the enactment of Section 7701(1).

[9] Application for purposes other than withholding tax. Under the Proposed Regulations, conduit treatment applies only for purposes of the taxes imposed on nonresident aliens and foreign corporations under Sections 871 and 881. While this is generally consistent with the recommendation in our prior report,[9]/ we do on reflection think that the final regulations should incorporate the concept of correlative adjustments. While the Internal Revenue Service should not be able to use the final regulations, in the audit of a foreign bank, for the sole purpose of excluding loans from the assets of the bank in determining its deductible interest expense under Regs. § 1.882-5, if the Internal Revenue Service does assert that the foreign bank is an intermediary and taxes the financing entity under Section 881 or 871, it should follow that a loan is not an asset of the foreign

[9]/ The proposed regulations with respect to the determination of the deductible interest expense of a foreign corporation should be conformed. See Prop. Regs. 1.882- 5(f), Example (3) (bank's loan is not a "booked liability" for purposes of step 3 where it is back-to- back with a deposit.)

bank for purposes of determining its interest expense[10] and that interest on the loan is not includible in the bank's income. If the Internal Revenue Service is sustained in its assertion with respect to the financing entity, the foreign bank or other intermediary should be entitled to assert affirmatively that its treatment of the transaction must be recharacterized on a consistent basis.

[10] Withholding obligations of unrelated intermediaries. If an intermediary is treated as a conduit, and a financing arrangement treated as directly between the financed and the financing party, the Proposed Regulations require the financed party or any "other" withholding agent to withhold on the basis of the recharacterized transaction, but only if the withholding agent knew or had reason to know that the financing transaction was subject to recharacterization. Knowledge will not be imputed if the withholding agent knew about the financing arrangement (i.e., knew about both of the financing transactions) but did not know enough to know that its participation was pursuant to a tax avoidance plan.

These withholding tax rules in effect make unrelated intermediaries, such as banks, police those transactions in which they have sufficient knowledge to know that there was an avoidance plan. While we generally approve of this approach, in the first instance the burden should not be on the unrelated intermediary to establish its lack of actual or assumed knowledge -- proving the absence of knowledge is extremely difficult. We therefore think that, in the first instance, the intermediary's lack of knowledge should be presumed and that the Internal Revenue Service should be required to provide a factual basis to

[10] The intermediary's "spread" might still be subject to U.S. tax, depending its source.

the contrary in order to rebut the presumption.[11]/ In addition, there should be an effective date rule which, at least for purposes of the liability of unrelated intermediaries, "grandfathers" payments made by unrelated intermediaries in transactions entered into prior to the issuance of the Proposed Regulations. It may be extraordinarily difficult for an unrelated intermediary to determine today whether the intermediary knew, or had reason to know, that a transaction entered into many years before involved a tax avoidance plan.

[11]/ The two rulings cited in the Notice of Proposed Rulemaking, Rev. Rul. 76-224 and Rev. Rul. 85-5, do not help much in determining when a withholding agent will be deemed to have knowledge for purposes of the Proposed Regulations.