

**New York State Bar Association  
Tax Section**

**Report On the Application of Anti-Conduit Regulations  
to Hybrid Entities and Instruments**

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This report<sup>1</sup> provides comments on proposed regulations amending Treasury Regulation section 1.881-3 (the “Anti-conduit Regulations”) issued on December 22, 2008 (the “Proposed Regulations”).<sup>2</sup>

Under the Anti-conduit Regulations, for withholding tax purposes, the Internal Revenue Service (the “IRS”) may disregard the participation of a conduit entity and recharacterize ostensibly separate financing transactions to which a conduit is a party as a direct financing between the ultimate provider and ultimate recipient of the financing. For such an intermediate entity to be a conduit: (1) there must be two or more “financing” transactions linked by the common “intermediate entity” or group of related entities (*i.e.*, a “financing arrangement”), (2) the participation of the intermediate entity must have the effect of reducing tax (measured against the U.S. withholding tax that would apply to a direct transaction between the provider and recipient of the financing), and (3) the participation of the intermediate entity must be pursuant to a tax avoidance plan (various non-exclusive indicia of which are provided in the regulations). As discussed below, the current definition of a “financing transaction” includes not only debt but also certain non-debt instruments (in particular, certain equity that is redeemable by its terms on or before a date certain).

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<sup>1</sup> The report was drafted principally by Andrew Walker, with the assistance of Drew Batkin and Joanna Grossman. Helpful comments and suggestions were provided by Kimberly Blanchard, Peter Blessing, Douglas Borisky, Andrew Braiterman, Peter Connors, Abraham Leitner, David Miller, Stephen Mills, Andrew Needham, Erika Nijenhuis, Yaron Reich, Michael Schler, Linda Swartz, Willard Taylor and Kirk Wallace. References in this report to “sections,” unless otherwise stated, are to the Internal Revenue Code of 1986, as amended (the “Code”).

<sup>2</sup> 73 Fed. Reg. 246 (December 22, 2008).

The Proposed Regulations provide that “disregarded entities” (within the meaning of Treasury Regulation section 301.7701-2), whose separate existence is ignored for most other federal income tax purposes, are treated as regarded “persons” for purposes of the Anti-conduit Regulations. The change would take effect once final regulations are issued, but may apply to payments made following the effective date under arrangements entered into prior to the effective date.

The preamble states that the U.S. Department of the Treasury (“Treasury”) and the IRS continue to study conduit financing arrangements and may issue separate guidance to address certain hybrid instruments, specifically instruments treated as debt under the tax laws of the foreign jurisdiction in which the issuer of the instrument is resident that are treated as equity for U.S. federal tax purposes. Currently, the regulations treat only limited kinds of redeemable equity as “financing transactions” and, accordingly, financing arrangements involving other instruments that are equity for U.S. federal income tax purposes are not subject to the Anti-conduit Regulations even if the instrument is debt for foreign tax law purposes.

The preamble suggests two possible approaches to these instruments. One alternative proposed is to treat any hybrid instrument classified as debt for local law purposes as a “financing transaction” for purposes of the anti-conduit rules. The other alternative proposed is to expand the factors that determine when equity in a corporation (or similar interests in a partnership or trust) constitutes a “financing transaction.” Factors of possible relevance to the treatment of an instrument as a financing transaction that are mentioned by the preamble include (1) intent of the parties to pay all or substantially all payments received by the intermediate entity to the financing party, (2) a history of paying amounts received by the intermediate entity to the financing party, and (3) precedence of the obligees over other creditors regarding the payment of interest and principal, currently or in bankruptcy.

This Report responds to the request in the preamble for comments on possible approaches to such hybrid instruments and factors that Treasury and the IRS should consider when deciding whether to expand the Anti-conduit Regulations.<sup>3</sup>

Part I of the Report summarizes our recommendations. Part II discusses the proposal in the Proposed Regulation to treat disregarded entities as regarded persons for purposes of the Anti-conduit Regulations. Part III of the Report discusses the possible expansion of the “financing transaction” definition in the regulations to reach certain hybrid instruments.

I. Summary of Recommendations

- A. We strongly support the proposed change to the Anti-conduit Regulations to treat disregarded entities as “persons” for purposes of the conduit analysis and agree with the proposed effective date for this change.
- B. We do not support revising the Anti-conduit Regulations to expand the definition of “financing transaction” to reach hybrid instruments generally. We do not think the need to prevent specific abusive transactions justifies the resulting complexity and increased administrative burden, in particular, for unrelated withholding agents. Instead, we recommend that specific abusive transactions not reached by the current regulations be addressed by describing and recharacterizing specific transactions of concern in the regulations and other guidance.
- C. However, if Treasury and the IRS are determined to expand the definition of a “financing transaction” to reach hybrid instruments generally, we have no strong preference as between (1) a definition that focuses on objective indicia designed to reach instruments that, while not redeemable or debt-like solely from the standpoint of the legal terms of the instrument, are structured to be, in practice, substantively very similar to arrangements covered by the existing definition of a “financing transaction” in the Anti-conduit Regulations and (2) an approach that focuses on the treatment of

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<sup>3</sup> The Report largely follows the terminology of the Anti-conduit Regulations. The entity that is the common party to the different legs of an overall financing arrangement and whose status as a potential conduit is at issue is referred to as the “Intermediate Entity.” The ultimate recipient of funding provided by the financing arrangements is referred to as the “Financed Entity” and the ultimate provider of funding as the “Financing Party.”

the instrument as debt under the law of the issuer's jurisdiction. Both approaches have advantages and disadvantages that we discuss below. To the extent the first approach is followed, however, we recommend that the indicia adopted should be objective because an approach that makes the definition of a "financing transaction" depend on the intent of the parties will be very difficult for taxpayers to administer.

## II. Treatment of Hybrid Entities

The Proposed Regulations on hybrid entities will preclude transactions that exploit potential inconsistencies between the treatment of entities as disregarded for general federal income tax purposes<sup>4</sup> but as "resident" in a treaty jurisdiction and therefore entitled to claim benefits for treaty purposes. The Proposed Regulations provide just one example of a transaction at which the change is aimed, which involves a foreign corporation in a non-treaty country (the Financing Party) that lends money to a U.S. person (the Financed Entity) via a "disregarded," wholly-owned subsidiary of the Financing Party located in a treaty country.

Example 1. FP, a foreign corporation organized in a jurisdiction that does not have an income tax treaty with the United States (*e.g.*, the Cayman Islands), lends \$1 million to DS, a corporation organized in the United States, in exchange for a note issued by DS. A year after making the original loan, FP assigns the DS note to FS, a wholly-owned foreign subsidiary of FP organized in a jurisdiction that has an income tax treaty with the United States (*e.g.*, the Netherlands) in exchange for a note issued by FS. The DS-FS income tax treaty eliminates withholding tax on interest and royalties. FS is a disregarded entity under the check-the-box regulations. After receiving notice of the assignment, DS remits payments due under its note to FS without withholding tax.<sup>5</sup>

As a condition to claiming the benefits of an income tax treaty, a claimant must be "resident" in the treaty jurisdiction. Treaty residence turns on whether the claimant is

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<sup>4</sup> See Treas. Reg. §§ 301.7701-2(c)(2), -3(b)(2)(C).

<sup>5</sup> See Prop. Reg. § 1.881-3(e), Ex. 2.

generally liable to tax in that treaty jurisdiction.<sup>6</sup> Because “residence” is specifically defined in treaty residence articles, an entity’s U.S. federal income tax classification generally is not relevant to this determination or its entitlement to treaty protection.<sup>7</sup> Unless a particular treaty includes specific rules for hybrid entities, treaty residence depends solely on the entity’s non-U.S. income tax treatment.<sup>8</sup> Accordingly, if the Netherlands subsidiary in the example above is liable to Netherlands corporate tax, it is a resident for purposes of the treaty. Such a disregarded entity could qualify as the “beneficial owner” of income for treaty purposes (assuming the entity would have been respected as the beneficial owner if it was not a disregarded entity for general federal income tax purposes). Accordingly, in the basic transaction above, the disregarded entity may qualify as a treaty resident person (*i.e.*, it is “regarded” for certain treaty qualification purposes despite being disregarded for most federal income tax purposes).

Certain taxpayers, in transactions like the one in the example above, apparently have taken the position that the Anti-conduit Regulations must be applied based on the general federal income tax treatment of disregarded entities. Thus, in the example above, it is asserted that the Netherlands intermediate entity cannot be an “intermediate entity” within the meaning of the Anti-conduit Regulations, because it is disregarded, and

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<sup>6</sup> United States Model Income Tax Convention of November 15, 2006, art. 4.1, *available at* <http://www.ustreas.gov/press/releases/reports/hp16801.pdf> (the “Model Treaty”).

<sup>7</sup> Although terms generally have the meaning given them under the law of the country whose tax is at issue in the particular situation, this is not the case when there is a specific treaty definition. *See* Model Treaty, art. 3.1.

<sup>8</sup> The regulations addressing hybrid entities under section 894(c) may preclude an owner of a hybrid entity from claiming treaty benefits on a “look-through” basis if its home country does not treat the entity as a pass-through. However, the regulations suggest that an entity disregarded for general U.S. federal income tax purposes may nevertheless claim the benefits of the treaty with its own country if it is actually liable to tax in that country. *Cf.* Treas. Reg. § 1.894-1(d)(5), Ex. 3 (hybrid entity taxed as partnership for U.S. tax purposes may claim treaty benefits).

therefore, not a separate “person” or entity in the first instance.<sup>9</sup> Similarly, transactions between that entity and its owner must be ignored in applying the regulations.

A taxpayer considering such a transaction would need to evaluate the effect of a number of potential challenges. To the extent the legal and economic terms of the two legs of the financing in the above example are substantially similar and the primary purpose of the arrangement is to avoid U.S. withholding tax, the common law conduit doctrine may apply to prevent treaty benefits being claimed. Alternatively, for similar reasons, the IRS might argue that the Netherlands disregarded entity is not the “beneficial owner” of the income for treaty purposes.<sup>10</sup> Given the purpose of the Anti-conduit Regulations, the IRS also might take the position that the terms “entity” or “person” as used in those regulations need not necessarily follow the general U.S. federal income tax treatment of an entity under the “check the box” rules if the entity is “regarded” for treaty purposes. We express no view on whether a taxpayer engaging in the transaction in the example would prevail on these issues. We assume for purposes of the remainder of this report that it would, and discuss below additional considerations.

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<sup>9</sup> Some other recent proposed regulations have specifically characterized a disregarded entity as not a “person” for U.S. federal income tax purposes. *See* Prop. Reg. § 1.901-2(f)(1)(i). *See also* Treas. Reg. § 1.1441-1(c)(8) (for purposes of chapter 3 of the Code, a disregarded entity is not a person); TAM 200807015 (Feb. 15, 2008) (foreign disregarded entity was not treated as a “person” for foreign tax credit purposes).

<sup>10</sup> We also note that such transactions could be precluded if the Administration’s recent budget proposals are enacted, as an entity organized in a different jurisdiction than the entity’s foreign owner may be treated as a corporation rather than a disregarded entity under that proposal. *See* Dept. of the Treasury, General Explanation of the Administration’s Fiscal Year 2010 Revenue Proposals 28 (May 2009). However, as the budget proposal appears aimed at disregarded entities owned by controlled foreign corporations (i.e., foreign corporations that are in turn controlled by U.S. taxpayers), possibly the provisions eventually enacted will not apply to a disregarded entity owned by a foreign corporation that is not a controlled foreign corporation.

The result reached in the example above may be precluded by the comprehensive limitation on benefits (“LOB”) provisions in certain treaties.<sup>11</sup> An entity that can satisfy the LOB active business test may be able to demonstrate that it lacks a tax avoidance plan for purposes of the Anti-conduit Regulation.<sup>12</sup> However, there may be other transactions that exploit the inconsistency between disregarding an entity for general purposes and treaty qualification that are not precluded by comprehensive LOB provisions.

Example 2. FP, a Bermuda company that was formerly a U.S. corporation, has shares listed and actively traded on a U.S. exchange. FP has a Luxembourg finance subsidiary (FS) that lends \$1 million to DS, another subsidiary corporation of FP that is organized in the United States. FS is disregarded for U.S. federal income tax purposes. FS funds itself primarily by borrowing from FP. FS is subject to Luxembourg net income tax but, as it is highly leveraged, FS has a low effective tax rate.

In this example, the basis for claiming the treaty exemption is that FS, although disregarded and although it has limited net income, is subject to net income tax in Luxembourg on that income. Accordingly, FS is a treaty resident. FS qualifies under the LOB provision of the Luxembourg treaty because it is ultimately owned in the United States. The FS-DS loan was originated by FS in the ordinary course of its financing activities. A direct loan from FP to DS would not have been entitled to treaty protection.

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<sup>11</sup> A typical LOB provision limits treaty benefits to persons that satisfy, in pertinent part, one of three tests: the public trading test, the ownership and base erosion test, or the active business test. A disregarded intermediary typically would not be in a position to rely on the “public trading” or “ownership and base erosion” tests, as an intermediate entity must be wholly owned by the non-treaty Financing Party (or one of the other parties to the financing arrangement) to be treated as disregarded. Such a disregarded intermediary typically would need to rely on the “active business” test and demonstrate that the financing income in question is connected to an active business it conducts in the treaty country.

<sup>12</sup> The active business test in most LOB provisions does not treat ‘financing’ as an active business for this purpose unless the entity is a bank or similar financial institution. Thus, to be covered by the active business test the income would have to be attributable to such an active financial business. However, financing activities undertaken in the ordinary course of an active trade or business of financing or risk management generally would not be considered as pursuant to a tax avoidance plan under the current Anti-conduit Regulations. *See* Treas. Reg. § 1.881-3(b)(3).

Example 3. FP, a foreign corporation organized in a treaty jurisdiction (e.g., Luxembourg) lends \$1 million to DS, a corporation organized in the United States, in exchange for a note issued by DS. FP is a treaty resident, for example, because its shares are regularly traded on a U.S. exchange. To fund the loan to DS, FP borrows from another subsidiary, FS, in a non-treaty jurisdiction (e.g., the Cayman Islands) on substantially similar terms. FS has elected to be treated as a disregarded entity. The DS-FP income tax treaty eliminates withholding tax on interest.

In Example 3 above, because FS is a disregarded entity under the check-the-box regulations, FP may argue that FS cannot be a Financing Party and there is no financing transaction between FS and FP. Accordingly, the Anti-conduit Regulations would not apply. However, had FS made the loan directly to DS, FP would have been entitled to claim treaty benefits only if it “derived” the income for purposes of section 894(c), which generally would be the case only if FP treated FS as a pass-through entity for purposes of FP country tax laws.

We agree that ignoring disregarded entities that effectively are “regarded” for treaty qualification purposes is inherently inconsistent with the purpose of the Anti-conduit Regulations, as the purpose of these regulations is to prevent treaty shopping. We see no substantive policy reason why disregarded entities that can claim treaty protection should be ignored, or treated more favorably than “regarded” entities, for purposes of the conduit analysis. Whatever the general merits of section 894(c) as a policy matter, we also see no substantive reason why the transaction in Example 3 should receive more favorable treatment than a direct loan from FS to DS under section 894(c).

Accordingly, we agree that the revisions to the treatment of hybrid entities made by the Proposed Regulations are appropriate, and we support their adoption. Further, we believe disregarding an entity that is “regarded” for purposes of claiming treaty benefits to be so clearly inconsistent with the policies and purposes of the Anti-conduit Regulations, that applying the revised regulations to payments made after the effective date -- even payments pursuant to arrangements entered into prior to the effective date --

is justified. Accordingly, we support the proposed effective date for the amendment to the Anti-conduit Regulations.

### III. Treatment of Hybrid Instruments

The appropriate treatment of hybrid instruments raises more difficult issues. We have found it challenging to fully evaluate the proposed approaches to hybrid instruments, because we do not know precisely what transactions are of concern to Treasury and the IRS, and the preamble does not elaborate. Accordingly, while the Report provides examples to illustrate particular points, no inference is intended that these necessarily are real-world examples or accurately describe the local tax treatment of particular transactions. It would be helpful for Treasury or the IRS to clarify the specific kinds of transactions that the potential amendments seek to address. We discuss one type of transaction for which we believe guidance is clearly appropriate in Section III.D, below.

The preamble suggests the transactions of concern generically involve an Intermediate Entity in a treaty country that provides financing to a U.S. Financed Entity. Presumably, the Intermediate Entity then raises funds for this U.S. financing by issuing a hybrid instrument (equity for U.S. tax purposes but debt for foreign tax purposes) to a Financing Entity in a country without a treaty or with a less favorable treaty. Presumably, however, the legal terms of the particular hybrid instrument do not require the issuer to redeem it by a date certain.<sup>13</sup>

Example 4. IE, an unlisted foreign corporation organized in an EU treaty jurisdiction, Country N, is owned by residents of that jurisdiction. IE lends \$1 million to DS, a corporation related to IE and organized in the United States, in exchange for a note issued by DS. FP, a corporation organized in a country that has a less favorable treaty income tax treaty with the United States advances

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<sup>13</sup> To the extent the instrument is mandatorily redeemable or the holder can force redemption, the existing Anti-conduit Regulations would already treat the instrument as a “financing transaction.” See Treas. Reg. § 1.881-3(a)(2)(ii)(A)(2); -3(a)(2)(ii)(B).

funds to IE in exchange for a “perpetual” subordinated debt instrument. Country N tax rules allow IE to deduct payments on perpetual debt and do not subject these payments to withholding tax. Deductible payments on the perpetual debt are not significant enough in the aggregate to cause IE to fail to satisfy the LOB base erosion test in the U.S.-Country N treaty.

To the extent payments are deductible for local law purposes, this reduces or eliminates the effective tax on the issuer of the instrument (IE) from participating in the arrangement. Assuming the hybrid instrument is properly treated as equity for U.S. federal income tax purposes and is not redeemable by its terms, it would not technically be a “financing transaction” within the meaning of, and accordingly the arrangement arguably could not be attacked under, the current Anti-conduit Regulations.

A. General Policy Considerations

Any expansion of the Anti-conduit Regulations to address hybrid instruments must reconcile certain conflicting policy considerations. Obviously, a primary goal is to impede treaty shopping and the use of intermediate entities primarily to obtain withholding tax benefits to which the parties would not otherwise be entitled. However, this must be tempered by administrability and efficiency considerations. Any change must also be consistent with existing treaty obligations of the United States.

The administrability of the Anti-conduit Regulations is of significant concern both for foreign parties who directly participate in multi-party financing arrangements and withholding agents. The U.S. withholding regime relies heavily on withholding agents to administer the applicable withholding rules and collect gross basis tax owed by foreign taxpayers.<sup>14</sup> However, withholding agents are frequently unrelated to the principal

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<sup>14</sup> There may be significant practical impediments to pursuing a foreign taxpayer directly. As a matter of public international law, courts of one sovereign will not enforce the tax judgments of another under the “revenue rule.” See *Moore v. Mitchell*, 30 F.2d 600, 604 (2d Cir. 1929) (L Hand, J. concurring), aff’d on other grounds, 281 U.S. 18 (1930). RESTATEMENT (THIRD) FOREIGN RELATIONS 483 (1987). Countries may depart from the revenue rule by bilateral treaty but the number of countries with which the United States has concluded such agreements is limited.

parties to a financing arrangement and typically have limited insight into their motivation for structuring a transaction or the foreign law treatment of the various legs of the transaction. Regulations recognize the practical difficulties faced by withholding agents in identifying conduit arrangements and excuse withholding agents from liability if they fail to deduct or withhold with respect to a conduit arrangement unless the agent “knows or has reason to know” the financing arrangement is a conduit arrangement.<sup>15</sup> While this exception provides some comfort, because the “reason to know” standard does not require actual knowledge, withholding agents face concerns about the level of due diligence they must conduct to ensure that knowledge of a conduit arrangement will not be imputed to them. To minimize the burden on withholding agents and allow them to police such financing arrangements, it is important that the applicable standards for conduit treatment be as clear and administrable as possible. Financing Parties who are unrelated to the other participants face similar concerns.<sup>16</sup>

Parties who engage in ordinary course multi-party financing transactions face concerns about the scope of the conduit rules even if they are privy to the underlying facts of the transaction. Although conduit treatment requires the existence of a “tax avoidance plan,” the regulations as drafted, in practice, grant very substantial discretion to the relevant IRS district director to impute such a plan and recharacterize

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<sup>15</sup> See Treas. Reg. § 1.1441-7(f)(2). This standard is satisfied if the withholding agent knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A withholding agent that knows only of the financing transactions that comprise the financing arrangement is not considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

<sup>16</sup> Treas. Reg. § 1.881-3(a)(3)(ii)(E)(2) (“a financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement only if the financing entity knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan.”)

transactions.<sup>17</sup> The “tax avoidance plan” test is ultimately subjective, and certain facts may create a presumption of such a plan.<sup>18</sup> Accordingly, even if a taxpayer knows a transaction is not tax motivated, it may be very difficult as an evidentiary matter to disprove that “one of” the principal purposes of an arrangement was avoidance of withholding tax if withholding tax in fact is reduced as a result of participation by an intermediate entity. Whether or not ordinary course transactions ultimately pass muster, the subjective nature of the “tax avoidance” rationale at a minimum involves uncertainty, risk of IRS challenge, and requires a more costly, fact-intensive analysis. Accordingly, relying on disproving the existence of a tax avoidance plan generally is a last resort. Financing parties invariably prefer to satisfy the other, more objective tests in the regulations.

The bright-line definition of financing arrangements and transactions serves to limit the universe of transactions that must be tested under the less objective “tax avoidance plan” standard; but within that universe, the IRS is given broad discretion to recharacterize participation by intermediaries that may be considered tax motivated. Thus, one can view the “financing arrangement” definitions as a “bright line” filter through which only those transactions more likely to raise substantive concerns will pass to the next stage in the analysis. Inherent in this careful compromise is a deliberate decision to exclude certain capital-raising transactions that might raise conduit concerns (for example, stock and guarantees) from the ambit of the regulations. Such excluded transactions are instead policed using existing common law conduit and other anti-avoidance doctrines.

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<sup>17</sup> See Treas. Reg. § 1.881-3(a)(3)(i) (the district director may determine that the participation of a conduit entity in a conduit financing arrangement should be disregarded and has discretion to determine the manner in which the standards for treatment as a conduit entity apply); Treas. Reg. § 1.881-3(a)(3)(ii)(A) (if the district director determines that the participation of a conduit entity in a financing arrangement should be disregarded, the transaction is recharacterized); Treas. Reg. § 1.881-3(b)(1) (the district director may “infer” the existence of a tax avoidance plan from the facts and circumstances).

<sup>18</sup> See, e.g., Treas. Reg. § 1.881-3(b)(2)(iii) (a short period of time between transactions is evidence of a tax avoidance plan).

In our view, a broad expansion of the kinds of instruments treated as financing transactions would require Treasury and the IRS to revisit generally the basic architecture of the regulations and the current compromise between bright line rules and more open-ended standards. Broadly defining financing transactions to include other stock or other non-debt arrangements that do not involve any legal obligations to repay an invested amount will weaken the “filtering” function served by the current “financing transaction” definition. At the extreme, for example, if “financing transaction” were defined to include any advance of funds or commitment to advance funds, the “financing arrangement” definition would become largely redundant; the conduit regulations would, in effect, simply give authority to disregard any intermediate entity whose participation in multi-party transactions was motivated by withholding tax avoidance. Conversely, if the basic architecture of the regulations is to be retained, any change in the “financing transaction” definition to reach hybrid instruments must be more narrowly tailored.

Taking into account the general considerations outlined above, we discuss below the advantages and disadvantages of various approaches to hybrid instruments that could be adopted.

B. Per Se Treatment of Hybrid Instruments as Financing Transactions

One general approach to hybrid instruments the preamble suggests is to treat any instrument that is debt under the law of the issuer’s jurisdiction but equity for U.S. federal income tax purposes as a per se “financing transaction” (the “Per Se Financing” approach).

Example 5. IE, an unlisted foreign corporation organized in an EU treaty jurisdiction, Country L, is owned by residents of that jurisdiction. IE lends \$1 million to DS, a corporation related to IE and organized in the United States, in exchange for a note issued by DS. FP, a corporation organized in a country that has a less favorable income tax treaty with the United States advances funds to IE in exchange for a subordinated instrument with limited creditor remedies that is convertible into common equity of IE. Country L tax rules characterize the

instrument as debt, allow IE to deduct payments on the instrument and do not subject these payments to withholding tax. Deductible payments on the instrument are not significant enough in the aggregate to cause IE to fail to satisfy the LOB base erosion test in the U.S.-Country L treaty.

If the Per Se Financing approach were adopted, the instrument in Example 5 would be a financing transaction merely because Country L classifies the instrument as debt. Objective features of the instrument that may make it more or less “debt like” from a U.S. perspective would be irrelevant. The status of the transaction as a conduit financing arrangement would depend on whether IE could disprove that its participation was pursuant to a tax avoidance plan.

The preamble does not explicitly explain why Treasury and the IRS are concerned about the non-U.S. tax law treatment of an instrument in relation to the Anti-conduit Regulations. Possibly, Treasury and the IRS believe that the foreign tax classification may serve as a short-hand way to identify characteristics of instruments that are “debt like,” and therefore to identify instruments that should constitute a “financing.” Alternatively, Treasury and the IRS may be concerned that local law debt treatment allows an intermediate entity to deduct payments on an instrument, effectively eroding the tax in the intermediate entity’s jurisdiction on the overall financing arrangements.

1. Foreign Classification as a Proxy for Debt

Under the Per Se Financing approach it would be irrelevant whether the instrument must be redeemed by a certain date or otherwise be “debt-like” from a U.S. perspective if the relevant foreign tax laws treat the instrument as debt. It may be that the country considers it debt based on the instrument having features the US tax rules consider debt-like. In those cases, the foreign tax law treatment may indeed serve as a “proxy” to identify instruments that may appropriately be considered “financing” transactions. However, whether an instrument presents conduit concerns from a U.S. tax perspective is imperfectly related to whether foreign tax laws treat the instrument as debt (or otherwise allow a deduction for payments on the instrument).

There could be a number of policy considerations that lead a country to treat an instrument as “debt”. It is not always the case that other countries will base debt classification on distinctions that approximate those followed by the U.S. federal tax system in distinguishing debt from equity. For example, a country may treat a subordinated instrument without a stated maturity or customary creditor remedies, or that is payable in equity, as debt if it is in the form of debt, because many other countries follow a more formalistic approach than the U.S. approach to characterizing instruments as debt.

In addition, different countries’ tax laws will have different standards. Thus, an instrument issued by an Intermediate Entity in one country may be a financing transaction under the Per Se Financing approach while an instrument with identical terms issued by an Intermediate Entity in another country would not be so treated.

Example 6. IE, a foreign corporation organized in an EU treaty jurisdiction, Country N, whose shares are publicly traded on a Country N exchange. IE lends \$1 million to DS, a corporation related to IE and organized in the United States, in exchange for a note issued by DS. FP, a corporation organized in a country that has a less favorable income tax treaty with the United States advances funds to IE in exchange for a subordinated certificate with limited creditor remedies that is convertible into common equity of IE. Country N tax rules do not classify the instrument as debt.

The instrument in Example 6 is substantially identical to that in Example 5. However, because Country N has different debt classification rules, the instrument would not be a financing transaction and this arrangement would not be subject to the Anti-conduit Regulations. Thus, the local law tax classification of instruments will not always serve as a reliable proxy to identify the kinds of “debt like” arrangements that should be within the ambit of the Anti-conduit Regulations.<sup>19</sup>

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<sup>19</sup> Similarly, if the test were formulated as whether or not local law permits a deduction, if a particular treaty country adopts a “cost of capital allowance” system rather than basing the deductibility of payments on the distinction between debt and equity, an intermediate entity in

## 2. Base Erosion Concerns

Another reason why debt classification might be considered an appropriate test for defining an instrument as a financing transaction might be that, to the extent the deduction of payments on an instrument issued to the Financing Entity reduces or eliminates the effective foreign tax the Intermediate Entity incurs as a result of participating in the financing arrangements, it is easier for an Intermediate Entity to participate solely to reduce U.S. withholding tax. Conversely, a meaningful tax burden in the Intermediate Entity's jurisdiction would make it less likely that the intermediate entity's participation in the financing was intended primarily to reduce U.S. withholding tax as this local tax burden could impose a significant "toll charge" on the Intermediate Entity's tax-motivated participation. Thus, the fact that an Intermediate Entity can participate in a financing arrangement without incurring a significant foreign tax cost could be a factor indicative of a potential conduit. This might justify treating the arrangements in Example 6 above more favorably than substantially similar arrangements in Example 5.

On the other hand, the fact that the instrument is classified as "debt" for local tax purposes will not necessarily mean that payments on the debt are actually deductible. For example, local tax law "thin capitalization" rules may disallow interest deductions in a particular case. Even if payments on an instrument classified as debt are deductible in fact, and the Intermediate Entity's tax burden has some bearing on its treatment as a conduit, it is less clear why the deductibility of payments on hybrid instruments issued to Financing Entities should be the only factor considered relevant to that tax burden. An Intermediate Entity's effective foreign tax burden from participating in a financing arrangement may reflect many factors, including a low (or zero) marginal tax rate in the relevant jurisdiction, its ability to shelter income from the financing arrangements using its other tax attributes or peculiarities of local law that allow the Intermediate Entity to

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that country could be treated as a conduit under the Per Se Financing approach even if one of the transactions in the overall arrangement was vanilla common stock.

exclude income from the U.S. financing leg of the transactions because that income is not sourced to the Intermediate Entity jurisdiction. For example, assuming the Intermediate Entity (IE) in Example 6 satisfies the public trading LOB test of the U.S.-Country N treaty, and therefore need not meet the treaty base erosion test, it might be so highly leveraged that the effective tax rate on IE's income in Example 6 is significantly lower than the effective tax rate on IE in Example 5. Accordingly, the deductibility or non-deductibility of payments on an instrument or treatment of the instrument as debt for foreign tax purposes is not a perfect proxy for whether the foreign tax "toll charge" will be a meaningful impediment to tax-motivated participation in a financing arrangement by an Intermediate Entity.<sup>20</sup> Nevertheless, although the deductibility of payments on the hybrid instrument may be an imperfect proxy, that arguably should not preclude its use as a relevant factor if this would prevent some abusive conduit transactions.

Alternatively, Treasury and the IRS may perhaps be concerned that treaty benefits be claimed only where this is necessary to avoid an actual double tax, and that deductions on the hybrid instrument not erode the foreign tax imposed on the U.S. leg of the financing arrangement. The notion that treaty benefits are premised upon preventing an actual "double tax" underlies other treaty anti-avoidance provisions, for example, the "base erosion" test contained in various treaty LOB provisions and section 894(c).<sup>21</sup> Whatever the general merits of this policy concern, however, we do not think this is properly a "conduit" concern, and it has not been invoked by the traditional common law anti-conduit rules or the current regulations as a reason for ignoring the participation of

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<sup>20</sup> Indeed, if the absence of a significant effective local tax on the financing arrangements should define what constitutes a "financing transaction," certain redeemable equity instruments, which the regulations currently treat as financing transactions, arguably should be excluded under that standard because they are not deductible debt for foreign tax purposes. It might be more appropriate to take into account a substantial local tax burden as a factor indicating that an Intermediate Entity is not a conduit. To the extent the foreign tax consequence to an Intermediate Entity of participating in a financing arrangement is made relevant under revised Anti-conduit Regulations, this could serve as one of the non-determinative factual indicia of a tax avoidance plan, rather than using the foreign tax treatment to define the kinds of transactions that are treated as financing transactions.

<sup>21</sup> See Treas. Reg. § 1.894-1(d)(1).

intermediate entities. Nor is that concern reflected in the legislative history of section 7701(l). In any event, as explained above, foreign law debt treatment of an instrument issued to the Financing Entity is imperfectly related to the actual effective foreign tax the Intermediate Entity will suffer as a result of participating in the financing arrangement.

If limiting treaty benefits to situations involving actual “double taxation” is the underlying policy concern motivating the possible changes to the Anti-conduit Regulations to deal with hybrid instruments, we think that policy would more appropriately be implemented by negotiating changes to treaty LOB provisions or, if that is not practicable in a reasonable time-frame, seeking revisions to section 894(c) to address hybrid instruments as well as hybrid entities. Section 894(c) is the provision concerned with ensuring that treaty benefits are available only to avoid actual double taxation. For better or worse, however, section 894(c) currently is limited to hybrid entities and does not provide authority to deny benefits where no local tax is actually incurred through use of hybrid instruments rather than hybrid entities.<sup>22</sup> We do not think this should be corrected, if correction is required, indirectly via the Anti-conduit Regulations, which otherwise do not reflect this underlying policy.

### 3. Relationship to Other Anti-avoidance Provisions

Another relevant consideration is whether the Per Se Financing approach would be consistent with existing treaty obligations of the United States. LOB provisions contained in most treaties already include a “base erosion” test that measures whether an entity that legally is a tax resident of a jurisdiction has too limited an effective tax nexus, because it makes deductible payments that substantially erode the tax base in the treaty

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<sup>22</sup> Congress was concerned that allowing an owner of an entity, which the U.S. tax system considers a “pass-through” entity, to claim treaty benefits derivatively would be inappropriate if the claimant’s residence country did not treat the income as passing through for its own tax purposes. The underlying premise is that treaties are intended to prevent double taxation; if there is no current residence-country tax due to hybrid treatment of an entity, its owner should not be allowed to claim treaty benefits merely because domestic U.S. principles consider the entity a pass-through.

jurisdiction.<sup>23</sup> This base erosion test applies at the entity level, generally based on whether payments deductible under local law exceed fifty percent of the entity's gross income. Extending conduit rules to reach a hybrid instrument solely on the basis that local law classifies the hybrid instrument as debt and that an Intermediate Entity therefore presumably may deduct payments on the Instrument for foreign tax purposes essentially would address the same concern, but would do so narrowly by reference to the financing arrangements themselves rather than at the level of the entity overall.

Example 7. IE, an unlisted foreign corporation organized in an EU treaty jurisdiction, Country N, is owned by residents of that jurisdiction. IE is an active central financing subsidiary and risk manager for an affiliated group of companies. Less than half of the deductible payments IE makes during the relevant years are made to persons outside Country N. IE lends \$1 million to DS, a corporation related to IE and organized in the United States, in exchange for a note issued by DS. FP, a corporation organized in a country that has a less favorable treaty income tax treaty with the United States advances funds to IE in exchange for a "perpetual" debt instrument. Country N tax rules treat the instrument as debt, allow IE to deduct payments on perpetual debt and do not subject these payments to withholding tax.

In this example, IE may satisfy the LOB (ownership and base erosion) provisions of the treaty because less than half of its overall income is offset by deductions to non-treaty parties. However, considered solely from the standpoint of the financing arrangements involving the loan to DS and perpetual debt issued to FP, IE may incur little or no incremental Country N tax from participating in the transaction.

We do not believe expanding the regulations to treat hybrid instruments like the perpetual debt above would directly conflict with the terms of treaty obligations in most cases (and presumably, the IRS could stipulate in expanded regulations that it would

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<sup>23</sup> The base erosion test generally applies only in the case of certain LOB tests for nexus, namely where nexus is otherwise established based on the ownership of the entity by treaty residents. It does not generally apply where nexus requirements are satisfied based on public trading in the entity's stock on a local or U.S. market or based on an item's connection to an active business in the treaty jurisdiction.

defer to treaty provisions in the case of direct conflict with specifically negotiated treaty conduit provisions). However, expanding conduit rules to reach such transactions solely on the basis of their foreign tax treatment could be viewed as inconsistent with the spirit of existing LOB provisions.

As applied to an entity that must otherwise satisfy an LOB base erosion test, as in the example above, conduit treatment premised on local tax deductibility arguably has a “heads we win - tails you lose” quality. If the treaty partner has negotiated through the treaty process a requirement that measures the effective local tax burden at the entity level, it could fairly complain that applying substantially the same test at the transactional level under revised domestic law conduit rules undermines the deal it has cut. Conversely, if a transaction must satisfy a requirement that local tax is actually borne on the income measured at the transactional level under conduit rules, why should a treaty deny benefits merely because the entity overall fails the base erosion test as to other income for which treaty benefits are not being claimed? Thus, in the example above, the tests for allowing treaty benefits could focus (1) on whether the particular transaction as to which treaty benefits are being claimed suffers tax in the other treaty country (tracing the specific financing that funds the U.S. leg of the transaction) or, alternatively, (2) whether the recipient actually is a significant taxpayer in that country (effectively viewing its aggregate financing as fungible), but it is less obvious why both requirements should have to be met.

On the other hand, the United States generally takes the position that domestic law limits on entitlement to treaty benefits (including conduit principles) remain applicable under its treaties.<sup>24</sup> To the extent the conduit rules are expanded to reach

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<sup>24</sup> See Model Treaty Technical Explanation, Art. 22, at 64 (“Article 22 and the anti-abuse provisions of domestic law complement each other, as Article 22 effectively determines whether an entity has a sufficient nexus to the Contracting State to be treated as a resident for treaty purposes, while domestic anti-abuse provisions (*e.g.*, business purpose, substance-over-form, step transaction or conduit principles) determine whether a particular transaction should be recast in accordance with its substance. Thus, internal law principles of the source Contracting State may be applied to identify the

cases of obvious abuse, the potential conflict with LOB provisions is less compelling. Moreover, a treaty partner is unlikely to have specifically negotiated the right to allow its taxpayers to be used as conduits. Nevertheless, the justification the United States has asserted for applying domestic law conduit principles as well as LOB provisions is that these domestic law principles identify the substantive beneficial owner of income. Unless the perpetual debt in Example 7 is secured by, or recourse is limited to, the DS loan, the application of the Anti-conduit Regulations based on a Per Se Financing rationale seems predicated on base erosion rather than whether IE in substance beneficially owns the income from the DS loan.

#### 4. Complexity and Administrability

Ignoring non-U.S. tax consequences, as the current Anti-conduit Regulations do, simplifies the task of those parties other than the intermediate entity that are involved in a financing arrangement. Unrelated parties are excused from withholding obligations resulting from a recharacterization under the Anti-conduit Regulations unless they know or have reason to know it is a conduit arrangement.<sup>25</sup> To the extent local tax treatment becomes relevant, such parties would face the question whether they have “reason to know” the classification for local law purposes of an instrument entered into by other parties to transactions in which they participate. Parties who otherwise would be indifferent to foreign tax rules would potentially have an obligation to inquire and take advice about foreign tax laws. This can be a time consuming and expensive endeavor. Accordingly, expanding the Anti-conduit Regulations to take account of non-U.S. tax consequences of the relevant transactions will certainly complicate what is already a complex regulation and will increase the costs, and hence economic inefficiencies, of complying with these rules.

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beneficial owner of an item of income, and Article 22 then will be applied to the beneficial owner to determine if that person is entitled to the benefits of the Convention with respect to such income.”)

<sup>25</sup> *Supra* note 16.

A possible solution would be to permit the withholding agent to rely on a representation of the issuer of an instrument regarding the local tax classification of that instrument as debt or equity. To the extent the Per Se Financing approach is adopted, it would be helpful to permit such reliance. However, unless a withholding agent could conclusively rely on such representations, this would ameliorate, but not resolve the withholding agent's dilemma. For example, if a withholding agent was permitted to rely on a representation regarding local law tax classification of an instrument "unless it has reason to know the representation is incorrect," the withholding agent would still be faced with the question of what diligence it should undertake and the need to take local tax advice if it wished to be certain of its obligations. Further, if the withholding agent is not a direct party to the contracts that document the financing transactions, it may be unable easily to negotiate such a representation and its only leverage to secure such a representation would be to threaten to withhold tax at a 30% rate. Threatening withholding to obtain a representation could place unrelated withholding agents in an awkward commercial position and expose the agent to litigation if the arrangement turns out not to be a conduit arrangement for other reasons.

C. Expanded Definition Based on Economic Similarity to Debt

The second approach posed by the preamble is to expand the factors to consider in determining when stock in a corporation (or other similar interest in a partnership or trust) constitutes a financing arrangement (the "Multi-Factor Approach"). As a general matter, deciding what additional factors to take into account in defining a "financing transaction" depends on what kinds of multi-party arrangements Treasury and the IRS are seeking to reach, and why. As explained above, we are uncertain precisely what these are. We suspect that the intent may be to reach instruments that are carefully structured to narrowly escape treatment as financing transactions under the technical requirements of the current Anti-conduit Regulations.

For reasons described above, any change other than a fairly narrow expansion of the existing class of financing transactions under the Multi-Factor Approach would require fundamentally rethinking the structure of the current regulations.

The “financing arrangement” definition is one of the “bright line” tests that restricts the reach of the regulations to avoid subjecting most financial transactions to a subjective and uncertain inquiry about whether the transaction has “a primary purpose” of avoiding withholding taxes. The architecture of the current regulations has three essential components: (1) there must be “financing” transactions linked by a common entity or group of related entities (*i.e.*, a financing arrangement), (2) the participation of the intermediary entity must have the effect of reducing tax (measured against the U.S. withholding tax that would apply to a direct transaction between the provider and recipient of the financing), and (3) the participation of the intermediate entity must be pursuant to a tax avoidance plan (various non-exclusive indicia of which are provided in the regulations).<sup>26</sup> The current Anti-conduit Regulations are not limited to “matched payment” situations.<sup>27</sup> Rather than focusing narrowly on the “nexus” between different

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<sup>26</sup> A further requirement is that the intermediary would not have entered into the transaction with the financed entity on the same terms “but for” the financing transaction with the financing party. However, the “but for” test only applies to transactions among unrelated participants. To the extent the participant would have been willing to enter into the transaction with the intermediate entity on similar terms without regard to the other legs of the transaction, this strongly suggests that the intermediary’s participation is not avoidant, in the sense that it could have entered into the U.S. leg of the transaction and achieved the desired tax result independent of the other transactions. Thus, although this test can be viewed as an additional requirement of causal nexus between the transactions, it can also be viewed merely as supplementing the general “tax avoidance plan” tests with a presumptive rule that there is no “avoidance” in that situation.

<sup>27</sup> By contrast, the common law conduit doctrine focuses heavily on the relationship between payments on the different legs of a multi-party financing transaction and generally disregards the participation of intermediate entities only when the payments on one leg of the transaction closely match payments on the other (the “matched payments rationale”). *See* Model Treaty Technical Explanation, at 34-5. The “matched payments” rationale under common law has the advantage of providing fairly clear, objective standards that do not implicate most ordinary course business transactions. The underlying theory is that if (1) an intermediary does not actually have “custody and control” of the income or (2) the transaction has been denuded of pre-tax economic consequences for the intermediary, its participation in the transaction should be ignored. *See, e.g., Aiken Industries, Inc.*, 56 T.C. 925 (1971); *cf. Northern Indiana Public Service Company*, 105 T.C. 341 (1995) (distinguishing *Aiken* because lenders in *NIPSCO* were third parties and intermediate entity derived

transactions, the Anti-conduit Regulations focus largely on whether the overall arrangement has the effect of reducing U.S. withholding tax and whether there are substantial non-tax reasons for the intermediary's involvement in the transactions.<sup>28</sup> This places significant pressure on the "financing arrangement" definition to limit the transactions that are within the scope of the regulations and therefore tested under the subjective tax-avoidance plan tests.

If the general approach of the current regulations is to be retained, in our view only a much more limited expansion in the scope of the "financing transaction" definition would be appropriate. For example, the kinds of equity treated as a financing transaction could be narrowly tailored to reach instruments that are substantively very similar to the instruments already treated as financing transactions, but which are structured to avoid the technical definition of a financing transaction. An example may be an equity instrument that is not by its terms redeemable or required to pay a current yield, but which is structured to achieve this result in practice. It may also be appropriate to address situations in which the equity instrument issued by an Intermediate Entity is not debt-like, but has been structured so that its returns closely match the returns on another financing between the Intermediate Entity and a U.S. Financed Entity.

The preamble suggests relevant factors might include whether the obligees under the instrument would take precedence over other creditors as to the payment of interest and principal, currently or in bankruptcy. That may be one consideration relevant to the debt-like nature of an instrument, but there are many others. For example, a similar

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significant earnings), *aff'd* 115 F.3d 506 (7<sup>th</sup> Cir. 1997). The common law conduit doctrine thus bears a strong resemblance to other common law anti-avoidance doctrines such as "constructive ownership" concepts and the treaty requirement that the claimant be the "beneficial owner" of income to claim treaty benefits.

<sup>28</sup> Treas. Reg. § 1.881-3(a)(4). An attenuated matching is required in the sense that both legs of the financing arrangement generally must involve legal repayment obligations to be "financing transactions" and, at least as among unrelated parties, there must be a "but for" relationship between the different legs of the multi-party financing.

effect could be achieved by limiting the permitted activities of the Intermediate Entity to minimize the likelihood there will be any third party senior creditors (even if in theory such creditors would prevail over the holder of the instrument in bankruptcy). An instrument that is legally senior to some creditors but subordinate to a practically important class of other creditors may be less debt-like than an instrument that is legally junior to all other creditors but issued by an entity not anticipated to have other creditors.

Thus, the problem with pursuing the approach of specifying those specific legal terms that indicate a financing is that either (1) if a single factor alone will determine “financing transaction” treatment, the tests would be overbroad or (2) if the various factors must be weighed, the analysis would devolve into much the same kind of multi-factor analysis that must be followed currently to determine whether an instrument is debt.

The preamble also mentions taking account of (1) the intent of the parties to pay all or substantially all payments received by the intermediate entity to the financing party or (2) history of payment of amounts received by the intermediate entity to the financing party. Such factors may be very hard to establish with certainty at the inception of a transaction (even one that is not in fact abusive), particularly by participants unrelated to the Intermediate Entity. Taking these factors into account explicitly will therefore undermine the utility of the “financing transaction” definition as a reasonably bright-line “filter” that circumscribes the kinds of arrangements subjected to scrutiny under the subjective “tax avoidance” tests. We therefore do not recommend a test for a “financing transaction” that is based on the intent of the parties.

If the Multi-Factor Approach were to be adopted, we suggest instead that the test for “debt like” instruments focus on the likelihood of repayment and existence of a fixed-income return rather than narrowly identifying legal terms of the instrument that may achieve this result. For example, a category like the following could be added to the classes of non-debt instruments defined as financing transactions:

An instrument that is not debt for federal income tax purposes (a “non-debt instrument”), such as corporate stock, a similar equity interest in a partnership or trust or a financial derivative (x) that is issued as part of an arrangement that as of the date of issuance has legal terms under which it is substantially likely that payments on the non-debt instrument of amounts will be at least equal to the original purchase price of the non-debt instrument within 30 years from the issue date and substantially all of the expected return from the non-debt instrument is attributable to the time value of the holder’s net investment in the instrument or (y) that is part of arrangements which include another financing transaction (or combination of other financing transactions) that would be part of a conduit financing arrangement that includes the non-debt instrument if the non-debt instrument were treated as a financing transaction, and the expected yield of such other financing transaction (or transactions) does not differ from the expected yield of the non-debt instrument by more than 5% of such yield, and changes in the yield of the non-debt instrument are reasonably expected to vary directly and proportionately with changes in the yield of such other financing transaction (or combination of transactions).

D. Application of Conduit Rules To Domestic Law Withholding Exemptions

Any expansion of the kinds of instruments treated as financing transactions, whether under the Per Se Financing approach or the Multi-Factor Approach, may exacerbate certain uncertainties with the application of the current Anti-conduit Regulations to arrangements that implicate the domestic law “portfolio interest” withholding exemption rather than involving treaty shopping.

The scope of the Anti-conduit Regulations is not confined to avoidance of U.S. withholding tax based on treaty benefits. The regulations also permit the Commissioner to disregard a conduit whose participation is intended to secure domestic law withholding exemptions that otherwise would be unavailable to the financing provider. For example, the regulations may permit the Commissioner to disregard the participation of a non-bank intermediate entity if the financing party is a bank that would not be entitled to the

portfolio interest exemption had it made a loan in the ordinary course of its lending business directly to the financed entity.<sup>29</sup>

Extending the “financing transaction” definition to more “equity-like” securities may reach results that could be viewed as inappropriate in the context of domestic law exemptions from withholding. Consider a variation on Example 5 above:

Example 8. IE, an unlisted foreign corporation organized in an EU treaty jurisdiction, Country L, is owned by residents of that jurisdiction. IE lends \$1 million to DS, a corporation related to IE and organized in the United States, in exchange for a note issued by DS. The note is in registered form and otherwise would satisfy the requirements of the “portfolio interest” exemption were IE not related to DS. FP, a bank organized in a country that does not have a favorable income tax treaty with the United States, advances funds to IE in exchange for a subordinated instrument with limited creditor remedies that is convertible into common equity of IE. Country L tax rules characterize the instrument as debt, allow IE to deduct payments on the instrument and do not subject these payments to withholding tax. Assume the instrument is properly characterized as equity for U.S. tax purposes.

If the stock were treated as a financing transaction under either the Per Se Financing approach or the Multi-Factor Approach, what would be the hypothetical recharacterized transaction between the financing party and the financed entity? The general rule in the regulations is that the character of payments made by the intermediate entity to the financing party governs this recharacterization. If so, withholding would apply to deemed dividend payments by the financed entity. That would be a peculiar result when the financing leg into the United States is actually a loan. An exception to the general recharacterization approach applies when the general rule would result in deemed payments by the financed entity that are non-deductible.<sup>30</sup> Accordingly, as dividends

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<sup>29</sup> Cf. Treas. Reg. § 1.881-3(e), Ex. 18.

<sup>30</sup> See Treas. Reg. § 1.881-3(a)(3)(ii)(B) (“If the participation of a conduit financing arrangement is disregarded under this paragraph (a)(3), payments made by the financed entity generally shall be characterized by reference to the character (e.g., interest or rent) of the payments made to the financing entity. However, if the financing transaction to which the financing entity is a

would not be deductible, perhaps the recharacterized transaction is a loan from the financing party to the financed entity. However, the regulations specify this exception may not be applied to extend an exemption dependent on facts and circumstances of the financing party-intermediate entity leg that are not actually present in the intermediate entity-financed entity leg of the transaction. Accordingly, it is not entirely clear whether the bank can argue that it has not made a loan in the ordinary course of its lending business and is therefore entitled to claim the portfolio interest exception.

This would be a peculiar result when the actual instrument purchased by the bank does not in any sense resemble a loan in the ordinary course, payments on the equity instrument do not closely match the payments on the loan, and the U.S. leg involves a loan otherwise clearly eligible for the portfolio interest exemption. While the transaction also may avoid treatment as a conduit transaction based on the absence of a tax avoidance plan, as discussed above, this analysis involves an inherently more subjective, and therefore uncertain, standard.

One possible way to address this would be to limit the scope of the Per Se Financing or Multi-Factor test to treaty shopping cases. In that case, any expansion of the “financing transaction” definition to reach instruments that do not give rise to interest (or, potentially, rent or royalties) for U.S. federal income tax purposes could be made applicable only when the Intermediate Entity’s participation achieves a reduction of U.S. tax based on treaty benefits. Alternatively, the rule for characterizing the deemed direct transaction between the Financing Entity and Financed Entity could be clarified.

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party is a transaction described in paragraph (a)(2)(ii)(A)(2) or (4) of this section that gives rise to payments that would not be deductible if paid by the financed entity, the character of the payments made by the financed entity will not be affected by the participation of a conduit entity. The characterization provided by this paragraph (a)(3)(ii)(B) does not, however, extend to qualification of a payment for any exemption for withholding tax under the Internal Revenue Code or a provision of any applicable tax treaty if such qualification depends on the terms of, or other similar facts or circumstances relating to, the financing transaction to which the financed entity is a party.”)

E. Target Specific Abuse Transactions

One approach not considered by the preamble would be to target transactions involving hybrid instruments with the general characteristics above only when these are clearly abusive and deliberately structured to avoid the reach of the current Anti-conduit Regulations, such as “rent a conduit” transactions.

Example 9. IE is a bank organized in an EU treaty jurisdiction, Country F, is publicly traded on the Country F exchange. IE advertises itself as willing to facilitate financing transactions with U.S. entities that otherwise would incur U.S. withholding tax. FP, which is organized in a non-treaty country wishes to engage in a financial transaction with DS, a U.S. corporation, which would otherwise attract U.S. withholding tax and approaches IE. IE issues subordinated perpetual debt to FP and on-lends the proceeds to DS. Recourse on the perpetual debt may be limited to the loan to DS or otherwise structured to reduce IE’s exposure to DS credit. Country F tax rules allow IE to deduct payments on perpetual debt and do not subject these payments to withholding tax and IE obtains favorable regulatory capital treatment.

There are a variety of factors that make the transaction in the above example objectionable from a conduit standpoint. A fundamental concern is that the Intermediate Entity participates in the transactions solely to obtain tax benefits for the Financing Party to which the Financing Party is not otherwise entitled. Indeed, the Intermediate Entity actively markets its services as a “conduit.” Although, by its terms, the hybrid instrument does not perfectly match the terms of the financing transaction with the Financed Entity, the Intermediate Entity by choosing to pay through any amounts received on the latter can achieve substantially the same effect. The Intermediate Entity may bear the credit risk of the Financed Entity, but this may not be a substantial risk depending on the credit quality of the Financed Entity and the collateral security it provides. The local tax treatment also ensures that the Intermediate Entity avoids any material incremental local tax burden if the deductible payments on the hybrid instrument offset the taxable income from the loan.

Taken alone, no one of the above features necessarily justifies conduit treatment. But taken as a whole, the combination of these features presents a compelling case for

conduit treatment. Rather than attempting to generalize from this transaction the features that cause the perpetual debt to be a financing transaction, the Anti-conduit Regulations could be amended to provide that a “financing arrangement” also includes any other multi-party financing arrangement identified in a Revenue Ruling, Revenue Procedure or Notice or any substantially identical transactions. Subsequent guidance could then be issued specifically describing objectionable transactions, like the rent-a-conduit transaction above, highlighting the features that are considered objectionable and defining the arrangement as a financing arrangement.

The benefit of this approach is that it would target specific transactions of concern without fundamentally undermining the architecture of the current regulations and the ability of taxpayers in ordinary course transactions to rely on the bright-line financing transaction definitions. In ordinary transactions, there would be no need for other parties to engage in a time consuming and complex consideration of the local tax treatment of the transaction applicable to the Intermediate Entity. This approach would also reduce the risk of conflicts with treaty partners as it would clearly be narrowly targeted at abusive transactions rather than adopting a domestic law base erosion test arguably inconsistent with negotiated treaty LOB provisions.

The obvious disadvantage of this approach is that it relies on the IRS being able to quickly identify abusive transactions and to shut them down through guidance before they become wide-spread. By contrast, the Per Se Financing Approach or Multi-Factor Approach could deter abusive transactions before they have been specifically identified by the IRS. For reasons, above, however, we believe it will be very difficult to generalize a set of features that should cause a non-debt transaction to be treated as a financing transaction without bringing many ordinary course transactions within the scope of the Anti-conduit Regulations and forcing the participants and withholding agents to contend with the subjective and uncertain tax avoidance plan tests. Unless such abusive transactions involving hybrid instruments are wide-spread, we do not think the resulting complexity and inefficiency is justified.

The IRS also retains the ability to apply the various other anti-avoidance doctrines where appropriate. These include (1) treaty requirement that the treaty claimant “beneficially own” the relevant income, (2) common law conduit principles, (3) common law “constructive ownership” and other “substance over form doctrines,” and (4) section 269. Other anti-avoidance doctrines could also be employed. We recognize that whether a challenge based on these doctrines will succeed remains uncertain other than in fairly clear cases of avoidance. However, if only a narrow class of transactions is of concern, one could question whether that concern justifies the complexity that will result from requiring an analysis of foreign tax results as part of the analysis under the Anti-conduit Regulations.

#### F. Recommendations

We do not support revising the Anti-conduit Regulations to expand the definition of “financing transaction” to reach hybrid instruments generally. We do not think the need to prevent specific abusive transactions justifies the resulting complexity and increased administrative burden, in particular, for unrelated withholding agents. Instead, we recommend that specific abusive transactions not reached by the current regulations be addressed by describing and recharacterizing specific transactions of concern in the regulations or other guidance. We recognize that this may preclude only those transactions the IRS has already identified as abusive. However, unless Treasury and the IRS believe the use of hybrid instruments to avoid the current Anti-conduit Regulations is widespread, we think this is a sensible compromise.

However, if Treasury and the IRS are determined to expand the definition of a “financing transaction” to reach hybrid instruments generally, we have no strong preference as between (1) a definition that focuses on objective indicia designed to reach instruments that, while not redeemable or debt-like solely from the standpoint of the legal terms of the instrument, are structured to be, in practice, substantively very similar to arrangements covered by the existing definition of a “financing transaction” in the Anti-conduit Regulations and (2) an approach that focuses on the treatment of the instrument

as debt under the law of the issuer's jurisdiction. Both approaches have advantages and disadvantages, as discussed. To the extent the first approach is followed, however, we recommend that the indicia adopted should be objective. We do not recommend an approach that makes the definition of a "financing transaction" depend on the intent of the parties, as this will be very difficult to administer.