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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR MARK E. O'LEARY
ASSOCIATE AREA COUNSEL AAC (LMSB:DAL:2)

FROM: Phyllis E. Marcus
Chief, Branch 2 CC:INTL:BR2

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated February 15, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be used or cited as precedent.

LEGEND

USCorp 1 =
FCorp 1 =
FCorp 2 =
FCorp 3 =
FCorp 4 =
Docket X =
Docket Y =
Country 1 =
Country 2 =
Country 3 =
$a =
$b =
Period 1 =
Period 2 =
Date 1 =
Date 2 =

Date 3 =
Year 1 =

ISSUES

1. Whether the doctrine of collateral estoppel applies in this case.

2. Whether FCorp 1 should be disregarded as a conduit entity under Treas. Reg. § 1.881-3.

CONCLUSIONS

1. Collateral estoppel is an affirmative defense which must be raised in a party's pleadings. T.C. Rule 39. An affirmative defense not pleaded is deemed waived and cannot be relied on by the party attempting to invoke the doctrine. *Niedringhaus v. Commissioner*, 99 T.C. 202 (1992); *Durovic v. Commissioner*, 84 T.C. 101 (1985). It is appropriate to waive collateral estoppel in this case based on the hazards of litigation involved.

2. Further factual development is necessary to determine whether FCorp 1 should be disregarded as a conduit entity under Treas. Reg. § 1.881-3. In general, it will be necessary to develop further facts regarding the debt and equity funding of FCorp 1, FCorp 3, and their affiliates.

FACTS

With respect to Issue 1, the facts as stated in the request for advice are incorporated by reference herein. In addition, it was learned from the field that no Rule 155 computations were submitted to the Tax Court in Dockets X or Y. With respect to Issue 2, a brief summary of the facts follows.

USCorp, a United States corporation, is a subsidiary of FCorp 2, a Country 1 corporation. During the years under examination, and also in prior taxable years, FCorp 2 directly or indirectly owned several other Country 1 and United States corporations which conducted a variety of service businesses.

One of these was a Country 1 subsidiary, FCorp 3, which in turn owned a Country 2 corporation, FCorp 4. When USCorp or the U.S. operating companies required capital, FCorp 2 would advance funds to FCorp 3 as debt or equity. FCorp 3 would advance the funds to FCorp 4 which, in turn, would transfer the funds to USCorp or one of the U.S. operating companies. The latter transfers were treated as debt for financial and tax purposes.

Prior to Date 1, all the FCorp 4 advances to USCorp and the U.S. operating companies were in substance refinanced, and were replaced by advances characterized as loans from FCorp 1, a Country 3 corporation wholly owned by FCorp 3. The U.S.-Country 3 Income Tax Treaty permits taxation of interest only by the state of residence, except for interest attributable to a permanent establishment or fixed base. FCorp 1 had no permanent establishment or fixed base in the U.S.

In and after late Year 1, when FCorp 1 replaced FCorp 4 as the entity used to fund USCorp and the U.S. operating subsidiaries, there were three basic patterns used to fund FCorp 1 advances. The first type involved advances booked by FCorp 3 as capital investments in FCorp 1. Typically, FCorp 1 issued new capital shares to FCorp 3 at the time of each advance. FCorp 1's first "loan" to USCorp, made on Date 2, is an example of this funding category.

There, FCorp 3 provided a $a capital injection to FCorp 1 on Date 2. At the time of the advance, FCorp 1 had approximately $b of other funds available. FCorp 1 then advanced the $a in funds to USCorp on the same day. FCorp 1 and USCorp booked the $a advance as a loan, establishing a repayment schedule for "interest" and "principal".

The second type of funding for the FCorp 1 advances came from "principal" and "interest" payments made on other FCorp 1 advances. FCorp 1 booked all the advances to USCorp and the U.S. operating companies as loans with scheduled "interest" and "principal" payments. When such payments occurred, FCorp 1 would invest the cash it received in short-term instruments for a period of time and would later advance the funds to USCorp or the U.S. operating companies. The period between FCorp 1's receipt of payments and its making new advances to US Corp and the U.S. operating companies ranged from Period 1 to Period 2. FCorp 3 provided no additional capital injections in connection with FCorp 1 advances funded in this fashion.

The last category is a mixture of the two other funding categories. Funding for this category came, in part, from new capital injections from FCorp 3 to FCorp 1, and, in part, from "principal" and "interest" payments made on prior FCorp 1 advances. Usually FCorp 3 injected an amount needed, when added to the "principal" and "interest" payments held by FCorp 1 in short-term investments, to make the requested advance to USCorp or one of the U.S. operating companies.

Consistent with their characterization of the advances as loans, USCorp and the U.S. operating companies, relying on the U.S.-Country 3 income tax treaty, did not withhold any tax under I.R.C. § 1442 on the "interest" payments to FCorp 1.

In contrast, if these payments had been treated as interest or dividend payments from USCorp and the U.S. operating companies to a related Country 1 corporation, the U.S.-Country 1 Income Tax Convention would apply, and the payments would have been subject to tax at a reduced (although non-zero) treaty rate.

FCorp 1's resident operations in Country 3 consist of one or two employees with leased office space at a Country 3 management company. FCorp 1 has written procedures for granting advances to FCorp 2 group companies. Under the procedures, the "borrower" is supposed to provide a request for the funds, together with details of the purpose for the "borrowing". When an acquisition funding is involved, the "borrower" is supposed to provide details of the target company. A credit review is to be prepared and submitted to the FCorp 1 Board of Directors. A Board meeting is usually held two days prior to the proposed funding date for the advance. Upon approval of the Board, FCorp 1 notifies the "borrower" and sends an offer letter outlining the terms and conditions of the loan. The advance is then funded with formal written loans documents being drafted at a later date. These written procedures envision little or no involvement in the process by FCorp 2 personnel, and facts demonstrating more substantial involvement by FCorp 2 personnel in the process have not been developed.

FCorp 1 invests excess funds in short-term investments. FCorp 1 has written procedures for investing these funds. The written procedures require FCorp 1 to obtain assistance from FCorp 2 personnel in Country 1 when placing an investment. With the exception of term deposits, FCorp 1's Controller is required to contact a person with FCorp 2's treasury staff when excess funds are invested. The treasury staff member then obtains quotes from various dealers on securities which meet FCorp 1's requirements. Those quotes are relayed to FCorp 1's Controller. After reviewing the quotes, FCorp 1's Controller then instructs the FCorp 2 treasury staff as to which securities to purchase. The FCorp 2 treasury staff member relays the instructions to brokers and prepares a schedule of the purchased investments. The schedule is faxed to the FCorp 1 Controller. Each day FCorp 1's Controller must fax a maturity analysis of the investments to the FCorp 2 treasury to enable FCorp 2 to monitor the group's worldwide liquid assets.

FCorp 1's Controller is authorized to deviate from the procedures with approval from FCorp 1's Board. The FCorp 1 written investment policy anticipates such deviations when a large amount of cash is needed for a stock redemption or a new "loan". In approved cases, the Controller is to place funds on deposit with a single bank the day before the funds are needed. This is designed to insure sufficient funds are readily available to fund the "loan" or the redemption. Under

FCorp 1's written investment policy, FCorp 1 must seek the advice of the FCorp 2 treasury before deciding to invest in asset backed investments.

FCorp 1's financial statements refer to the fact that the company may enter into currency hedges with respect to assets and liabilities denominated in foreign currencies. However, the financial statements reflect no currency hedges in existence during the periods at issue. There is no evidence FCorp 1 entered into interest rate hedging during the years at issue.

LAW AND ANALYSIS

Collateral estoppel.

The Associate Area Counsel concluded that given the factual differences and the lack of a final decision based on the Tax Court's opinion, a court would not apply collateral estoppel. We concur with that conclusion, and note the following additional considerations.

Generally, the doctrine of collateral estoppel applies to prevent relitigation between the same parties of issues of law that were decided in an earlier proceeding on a different cause of action. *Hudson v. Commissioner*, 100 T.C. 590, 593 (1993), *aff'd.*, 71 F.3d 877 (5th Cir. 1995). Collateral estoppel also applies to findings of fact that were actually litigated and decided in an earlier proceeding between the same parties and that were essential to the judgment entered in the earlier proceeding. *Id*. Collateral estoppel does not apply to issues of law or findings of fact if the party against whom collateral estoppel is asserted did not have a full and fair opportunity to litigate the issues of law or the findings of fact in the earlier proceeding. *Id*.

In the instant case, the Tax Court issued an opinion. The decision of the Court, however, did not reflect its opinion. Instead, the decision was stipulated by the parties. Because the Court's opinion was not reflected in the decision, collateral estoppel is likely not available for the following reasons.

In the case of a decision or judgment based on a settlement, none of the issues is generally considered actually litigated. See Restatement (Second) of Judgments § 27 cmt. e. (1980); *Kroh v. Commissioner*, 98 T.C. 383, 401 (1992). In the instant case, however, it can be argued that the party against whom collateral estoppel is asserted had an opportunity to actually litigate the issues because the trial court's opinion reflects a resolution of the issues. This position would likely fail because the court's opinion is not a final decision. The decision of the Tax Court is, in most cases, based upon its opinion. The decision is “entered” by the court and appeal is taken from the court’s decision.

Where a trial court’s judgment or decision is vacated, reversed, or set aside by an appellate court, collateral estoppel will not apply to the trial court’s conclusions of law or findings of fact. *Hudson*, 100 T.C. at 593. Likewise, where a trial court’s conclusions are challenged on appeal and where the appellate court affirms the trial court’s judgment on grounds different from those relied on by the trial court and does not decide on the trial court’s conclusions, collateral estoppel will not apply. *Id*. at 593-594. The rationale is that if the appellate court does not pass judgment on a trial court’s conclusions with regard to a particular issue, the party who lost before the trial court has not had a full and fair opportunity to litigate the issue at the appellate level. *Id*. at 594. Where the trial court’s conclusions are effectively set aside, they cannot be used as the basis for collateral estoppel in a subsequent proceeding between the same parties. *Id.*

In the instant case, the stipulated settlement entered into by the parties effectively set aside the Tax Court’s conclusions of law and findings of fact. The Tax Court’s opinion could not be appealed, only the entered decision. Therefore, a full and fair opportunity to litigate the issue did not exist and collateral estoppel will likely not apply.

Even assuming the issue was actually litigated, it was not essential to the judgment entered by the Tax Court. Collateral estoppel will not apply to findings of fact that were actually litigated and decided in an earlier proceeding between the same parties unless those findings were essential to the judgment entered in the earlier proceeding. *Hudson*, 100 T.C. at 593. In the instant case, the Tax Court’s findings of fact were not essential to the judgment or decision that was actually entered. In fact the decision did not reflect the Court’s findings. Thus, collateral estoppel will likely not apply.

Even assuming the issue was actually litigated and essential to the judgment, the present issue is not identical to the first suit. Collateral estoppel does not apply unless the issue is “identical in all respects” to the first suit. *Peck v. Commissioner*, 90 T.C. 162, 166-167 (1988), *aff’d*, 904 F.2d 525 (9^{th} Cir. 1990).

For the years at issue in this cycle, the facts state that the FCorp 2 group began using a new funding vehicle for the advances to the U.S. operating companies. Prior to Date 1, all the FCorp 4 advances to USCorp and the U.S. operating companies were shifted to FCorp 1, which began to issue the advances. The Tax Court’s opinion was based, in part, on a review of the relationship between petitioners and FCorp 4. The Tax Court, however, did not examine the relationship between the petitioners and FCorp 1. The use of FCorp 1 to issue advances during the years at issue, as well as any differences in arranging the advances, will likely preclude a finding that the current issue is identical to the one previously decided by the Court. For this reason, collateral estoppel will likely not apply.

Conduit analysis under Treas. Reg. § 1.881-3.

As discussed more fully below, Treas. Reg. § 1.881-3(a)(1) gives the District Director the authority, pursuant to I.R.C. § 7701(l), to disregard for purposes of I.R.C. § 881 the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities. Treas. Reg. § 1.881-3(a)(1). (Pursuant to a reorganization, certain authority previously exercised by District Directors was delegated to the Division Commissioner and thence to LMSB Directors and Deputy Directors, see Commissioner Delegation Order 193, reprinted in IRM 1.2.2.107, and LMSB Delegation Order No. 026-193 (Rev. 6), effective October 1, 2000. The term "Director" is used below with respect to the latter persons.) Corresponding adjustments are made with respect to chapter 3 withholding requirements that are treated as arising by virtue of such recharacterizations. See Treas. Reg. §§ 1.1441-3(g) and 1.1441-7(f). The conduit regulations and the corresponding withholding tax obligations both are effective with respect to payments made by financed entities on or after September 11, 1995, but do not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest obligations issued prior to October 15, 1984. Treas. Reg. §§ 1.881-3(f), 1.1441-3(g)(2), 1.1441-7(f)(3).

A "financing arrangement" means a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities); and, except in certain situations where related parties are involved (discussed more fully below), there are "financing transactions" linking the financing entity, each of the intermediate entities, and the financed entity. A transfer of money or other property in satisfaction of a repayment obligation is not treated under the regulations as an advance of money or other property. A financing arrangement exists regardless of the order in which the transactions are entered into, but only for the period during which all of the financing transactions coexist. Treas. Reg. § 1.881-3(a)(2)(i)(A).

If two (or more) financing transactions involving two (or more) related persons would form part of a financing arrangement but for the absence of a financing transaction between the related persons, the Director may treat the related persons as a single intermediate entity, if the Director determines that one of the principal purposes for the structure of the financing transactions is to prevent the characterization of such arrangement as a financing arrangement. This determination shall be based upon all of the facts and circumstances, including, without limitation, the factors set forth in Treas. Reg. § 1.881-3(b)(2). Treas. Reg. § 1.881-3(a)(2)(i)(B). See Treas. Reg. § 1.881-3(e), Example (5), which illustrates the operation of Treas. Reg. § 1.881-3(a)(2)(i)(B).

In general, a financing transaction means: (a) debt; (b) certain stock in a corporation (or a similar interest in a partnership or trust) that meets the requirements of Treas. Reg. § 1.881-3(a)(2)(ii)(B); (c) any lease or license; or (d) any other transaction pursuant to which a person makes an advance of money or other property or grants rights to use property to a transferee who is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value. A financing transaction does not include the posting of collateral unless the collateral consists of cash or the person holding the collateral is permitted to reduce the collateral to cash (through a transfer, grant of a security interest or similar transaction) prior to default on the financing transaction secured by the collateral. Treas. Reg. § 1.881-3(a)(2)(ii)(A).

Stock in a corporation (or a similar interest in a partnership or trust) constitutes a financing transaction only if: (a) the issuer is required to redeem the stock or similar interest at a specified time or the holder has the right to require the issuer to redeem the stock or similar interest or to make any other payment with respect to the stock or similar interest; (b) the issuer has the right to redeem the stock or similar interest, but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur; or (c) the owner of the stock or similar interest has the right to require a person related to the issuer (or any other person who is acting pursuant to a plan or arrangement with the issuer) to acquire the stock or similar interest or make a payment with respect to the stock or similar interest. Treas. Reg. §1.881-3(a)(2)(ii)(B)(1). Certain special rules apply to determine whether, for purposes of Treas. Reg. §1.881-3(a)(2)(ii)(B)(1), a person will be considered to have a right to cause a redemption or payment. For this purpose, a person will not be considered to have such a right if the right is derived solely from ownership of a controlling interest in the issuer in cases where the right does not arise from a default or similar contingency under the instrument. The person is considered to have such a right if the person has the right as of the issue date or, as of the issue date, it is more likely than not that the person will receive such a right, whether through the occurrence of a contingency or otherwise. Treas. Reg. §1.881-3(a)(2)(ii)(B)(2).

A "conduit entity" means an intermediate entity whose participation in the financing arrangement may be disregarded in whole or in part, pursuant to Treas.

Reg. § 1.881-3, whether or not the Director makes a determination that the intermediate entity should be disregarded under Treas. Reg. § 1.881-3(a)(3)(i). Treas. Reg. § 1.881-3(a)(2)(iii). A "conduit financing arrangement" means a financing arrangement that is effected through one or more conduit entities. Treas. Reg. § 1.881-3(a)(2)(iv). "Related" means related within the meaning of sections 267(b) or 707(b)(1), or controlled within the meaning of section 482, and the regulations under those sections. For purposes of determining whether a person is related to another person, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

Under Treas. Reg. § 1.881-3(a)(4), in general, an intermediate entity (or entities) is a conduit entity with respect to a financing arrangement if the participation of the intermediate entity (or entities) in the financing arrangement reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would have been imposed under Treas. Reg. § 1.881-3(d)), the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan, and either the intermediate entity is related to the financing entity or the financed entity, or the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity. If a financing arrangement involves multiple intermediate entities, the Director will determine whether each of the intermediate entities is a conduit entity. Treas. Reg. § 1.881-3(a)(4)(ii)(A). The Director may treat related intermediate entities as a single intermediate entity if he determines, based on all the facts and circumstances, that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or to otherwise circumvent the provisions of Treas. Reg. § 1.881-3. Treas. Reg. § 1.881-3(a)(4).

A "tax avoidance plan" is a plan one of the principal purposes of which is the avoidance of tax imposed by section 881. In this regard, the only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement and not those pertaining to the existence of a financing arrangement as a whole. The plan may be formal or informal, written or oral, and may involve any one or more of the parties to the financing arrangement. The plan must be in existence no later than the last date that any of the financing transactions comprising the financing arrangement is entered into. The Director may infer the existence of a tax avoidance plan from the facts and circumstances. In determining whether there is a tax avoidance plan, the Director will weigh all relevant evidence regarding the purposes for the intermediate entity's participation in the financing arrangement. Treas. Reg. § 1.881-3(b)(1)

Under Treas. Reg. § 1.881-3(b)(2), the factors taken into account in determining whether the participation of an intermediate entity in a financing arrangement has as one of its principal purposes the avoidance of tax imposed by section 881 include, but are not limited to, the following:

a. Significant reduction in tax. The Director will consider whether the participation of the intermediate entity (or entities) in the financing arrangement significantly reduces the tax that otherwise would have been imposed under section 881. The fact that an intermediate entity is a resident of a country that has an income tax treaty with the United States that significantly reduces the tax that otherwise would have been imposed under section 881 is not sufficient, by itself, to establish the existence of a tax avoidance plan. The determination of whether the participation of an intermediate entity significantly reduces the tax generally is made by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would be imposed under Treas. Reg. § 1.881-3(d). However, the taxpayer is not barred from presenting evidence that the financing entity, as determined by the district director, was itself an intermediate entity and another entity should be treated as the financing entity for purposes of applying this test. A reduction in the absolute amount of tax may be significant even if the reduction in rate is not. A reduction in the amount of tax may be significant if the reduction is large in absolute terms or in relative terms.

b. Ability to make the advance. The Director will consider whether the intermediate entity had sufficient available money or other property of its own to have made the advance to the financed entity without the advance of money or other property to it by the financing entity (or in the case of multiple intermediate entities, whether each of the intermediate entities had sufficient available money or other property of its own to have made the advance to either the financed entity or another intermediate entity without the advance of money or other property to it by either the financing entity or another intermediate entity).

c. Time period between financing transactions. The Director will consider the length of the period of time that separates the advances of money or other property, or the grants of rights to use property, by the financing entity to the intermediate entity (in the case of multiple intermediate entities, from one intermediate entity to another), and ultimately by the intermediate entity to the financed entity. A short period of time is evidence of the existence of a tax avoidance plan while a long period of time is evidence that there is not a tax avoidance plan.

d. <u>Financing transactions in the ordinary course of business.</u> If the parties to the financing transaction are related, the Director will consider whether the financing transaction occurs in the ordinary course of the active conduct of complementary or integrated trades or businesses engaged in by these entities. If so, that fact is evidence that the participation of the parties to that transaction in the financing arrangement is not pursuant to a tax avoidance plan. A loan will not be considered to occur in the ordinary course of the active conduct of complementary or integrated trades or businesses unless the loan is a trade receivable or the parties to the transaction are actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons.

Treas. Reg. § 1.881-3(b)(3)(i) establishes a rebuttable presumption that an intermediate entity's (or entities') participation in a financing arrangement is not pursuant to a tax avoidance plan if the intermediate entity is related to either or both the financing entity or the financed entity and the intermediate entity performs "significant financing activities" with respect to the financing transactions forming part of the financing arrangement to which it is a party. This presumption may be rebutted if the Director establishes that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan.

An intermediate entity performs significant financing activities with respect to a financing transaction only if the entity satisfies one of two tests. Treas. Reg. § 1.881-3(b)(3)(ii). Under the first test (styled "active rents and royalties"), the intermediate entity will be treated as performing significant financing activities with respect to leases or licenses if rents or royalties earned with respect to such leases or licenses are derived from the active conduct of a trade or business within the meaning of section 954(c)(2)(A) (substituting the term "intermediate entity" for "controlled foreign corporation"). Treas. Reg. § 1.881-3(b)(3)(ii)(A).

Under the second test (styled the "active risk management" test), in general, an intermediate entity is considered to perform significant financing activities with respect to financing transactions only if its officers and employees participate actively and materially in arranging the intermediate entity's participation in such financing transactions (other than financing transactions involving certain trade receivables and payables, discussed below); perform certain enumerated business activity and risk management activities (discussed in the following paragraph) with respect to such financing transactions; and the participation of the intermediate entity in the financing transactions produces (or reasonably can be expected to produce) efficiency savings by reducing transaction costs and overhead and other fixed costs.

For purposes of the active risk management test, the necessary “business activity and risk management requirements” are met with respect to a financing transaction only if, within the country in which the intermediate entity is organized (or, if different, within the country with respect to which the intermediate entity is claiming the benefits of a tax treaty), its officers and employees exercise management over, and actively conduct, the day-to-day operations of the intermediate entity. Such operations must consist of a substantial trade or business or the supervision, administration and financing for a substantial group of related persons. The officers and employees also must actively manage, on an ongoing basis, material market risks arising from such financing transactions as an integral part of the management of the intermediate entity's financial and capital requirements (including management of risks of currency and interest rate fluctuations) and management of the intermediate entity's short-term investments of working capital by entering into transactions with unrelated persons. Treas. Reg. § 1.881-3(b)(3)(ii)(B)(2).

Notwithstanding the foregoing, if the activities of the intermediate entity consist in whole or in part of cash management for a controlled group of which the intermediate entity is a member, then employees of that entity need not have participated in arranging any such financing transactions that arise in the ordinary course of a substantial trade or business of either the financed entity or the financing entity. Officers or employees of the financing entity or financed entity, however, must have participated actively and materially in arranging the transaction that gave rise to the trade receivable or trade payable. Treas. Reg. § 1.881-3(b)(3)(ii)(B)(3).

Except as provided in the preceding paragraph, the activities of an intermediate entity’s officer or employee generally will not constitute significant financing activities if any officer or employee of a related person participated materially in any of the activities described in Treas. Reg. § 1.881-3(b)(3)(ii) (dealing with the active management of material market risks), other than to approve a guarantee of a financing transaction or to exercise general supervision and control over the policies of the intermediate entity. Treas. Reg. § 1.881-3(b)(3)(ii)(B)(4).

The determination of whether an intermediate entity would not have participated in a financing arrangement on substantially the same terms but for the financing transaction between the financing entity and the intermediate entity shall be based upon all of the facts and circumstances. In general, the Director may presume that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if there is a guarantee of the financed entity's liability to the intermediate entity (or in the case of multiple intermediate entities, a guarantee of the intermediate entity's liability to the intermediate entity that advanced money or property, or granted rights to use other property). However, a guarantee that was neither in existence nor contemplated on the last date that any of the financing transactions comprising the financing arrangement is entered into does not give rise to this presumption. A taxpayer may rebut this presumption by producing clear and convincing evidence that the intermediate entity would have participated in the financing transaction with the financed entity on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity. For purposes of this paragraph, a guarantee is any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another person's obligation with respect to a financing transaction. The term shall be interpreted in accordance with the definition of the term in I.R.C. § 163(j)(6)(D)(iii).

If the Director determines that the participation of a conduit entity in a financing arrangement should be disregarded, the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement (for the most part, the financed entity and the financing entity) for purposes of I.R.C. § 881. To the extent the disregarded conduit entity actually receives or makes payments pursuant to the conduit financing arrangement, it is treated as an agent of the financing entity. Treas. Reg. § 1.881-3(a)(3)(ii)(A).

Where a conduit entity is disregarded, payments made by the financed entity generally are characterized by reference to the character (rent or interest) of the payments made to the financing entity. Treas. Reg. § 1.881-3(a)(3)(ii)(B). However, if the financing transaction to which the financing entity is a party is a transaction described in paragraph Treas. Reg. § 1.881-3(a)(2)(ii)(A)(2) or (4) 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 disregard of the participation of a conduit entity. The conduit entity may not claim the benefits of a tax treaty between its country of residence and the U.S. to reduce the amount of tax due under I.R.C. § 881. The financing entity may claim the benefits of any tax treaty under which it is entitled to reduce the rate of tax on payments made pursuant to the conduit financing arrangement. Treas. Reg. § 1.881-3(a)(3)(ii)(C).

Treas. Reg. § 1.881-3(d) addresses certain other computations under section 881 if a financing arrangement is treated as a conduit financing arrangement. In general, a portion of each payment made by the financed entity with respect to the financing transactions that comprise the conduit financing arrangement shall be recharacterized as a transaction directly between the financed entity and the financing entity. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, the entire amount of the payment shall be so recharacterized. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is greater than the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, then the recharacterized portion shall be determined by multiplying the payment by a fraction the numerator of which is equal to the lowest aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement (other than financing transactions that are disregarded pursuant to Treas. Reg. §§ 1.881-3(a)(2)(i)(B) and 1.881-3(a)(4)(ii)(B)) and the denominator of which is the aggregate principal amount of the financing transaction(s) to which the financed entity is a party.

Certain special rules apply to a financing entity that is unrelated to both intermediate entity and financed entity. In such a case, even if a financing arrangement is a conduit financing arrangement, a financing entity that is unrelated to the financed entity and the conduit entity (or entities) is not itself liable for tax under section 881 unless the financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement. The withholding agent's obligations in respect of such an unrelated financing entity, however, are unaffected by this rule.

In general, 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. A person that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

For purposes of these rules, it is presumed that the financing entity does not know or have reason to know that the financing arrangement is a conduit financing arrangement if the financing entity is unrelated to all other parties to the financing arrangement and the financing entity establishes that the intermediate entity who is a party to the financing transaction with the financing entity is actively engaged in a substantial trade or business. An intermediate entity will not be considered to be engaged in a trade or business if its business is making or managing investments, unless the intermediate entity is actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. An intermediate entity's trade or business is substantial if it is reasonable for the financing entity to expect that the intermediate entity will be able to make payments under the financing transaction out of the cash flow of that trade or business. This presumption may be rebutted if the district director establishes that the financing entity knew or had reason to know that the financing arrangement is a conduit financing arrangement. See Treas. Reg. § 1.881-3(a)(3)(ii)(E), and Treas. Reg. § 1.881-3(e), Example 6.

Associate Area Counsel has requested our views with respect to whether, under Treas. Reg. § 1.881-3, the Director might in effect disregard FCorp 1's participation in the funding of USCorp and the U.S. operating companies so that interest paid by USCorp and the U.S. operating companies to FCorp 1 would be treated as having been paid, for withholding tax purposes, to FCorp 3, a Country 1 corporation. In that case, those payments would be subject to reduced rates of withholding under the U.S.-Country 1 Income Tax Treaty, rather than being wholly exempt under the U.S.-Country 3 Income Tax Treaty.

Based on the information provided, we cannot conclude that Treas. Reg. § 1.881-3 supports this position. It is not possible to determine from the information provided whether any of FCorp 3's stock (equity) interests in FCorp 1 are financing transactions within the meaning of Treas. Reg. § 1.881-3(a)(2)(ii)(B). Under that section, the Director may disregard FCorp 1 for purposes of I.R.C. §§ 881 and 1442 as an intermediate entity in a conduit financing arrangement between FCorp 3 as a financing entity and USCorp and/or the U.S. operating companies as financed entities only if FCorp 3's stock interests in FCorp 1 bear certain debt-like characteristics and so may be considered to be financing transactions. This would be the case if, for example, FCorp 1 is required to redeem its stock from FCorp 3 at a specified time, or if FCorp 3 has the right to require FCorp 1 to make such a redemption. Alternatively, FCorp 3's FCorp 1 stock interests would constitute a financing transaction if FCorp 1 has a redemption right and, at the date of issuance, based on all the facts and circumstances, it is more likely than not that the stock would be redeemed. Lastly, FCorp 3's stock in FCorp 1 can constitute a financing transaction if FCorp 3 has the right to require a related person to acquire or make a payment with respect to the stock.

If FCorp 3's stock interests in FCorp 1 are not financing transactions, Treas. Reg. § 1.881-3(a)(2)(i)(B) nonetheless may apply to allow the Director to recharacterize, for purposes of I.R.C. §§ 881 and 1442, the tax treatment of some or all of FCorp 1's advances to USCorp and the U.S. operating companies if certain additional facts exist and are developed. This would be the case if contemporaneous financing transactions in which FCorp 3 has received funds from persons related to it (such as FCorp 2 or another affiliate), or from unrelated persons, exist and can be documented.

Even if such transactions cannot be documented, both FCorp 1 and FCorp 3 might be treated as disregarded conduit entities with respect to any financing arrangement in which FCorp 2 or some other person is determined to have received advances in financing transactions that were then, through two (or more) tiers of non-financing transactions, made available to USCorp or the U.S. operating companies. If such a chain of financing and non-financing transactions can be documented, the Director might conclude, based on all the facts and circumstances, that both FCorp 3 and such other affiliate(s) are multiple conduit entities that should be treated as a single disregarded entity because one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or to otherwise circumvent the provisions of Treas. Reg. § 1.881-3.

Some of the facts described above clearly support the proposition that FCorp 1's advances to USCorp and other U.S. operating companies should be treated as financing transactions that are part of a conduit financing arrangement under Treas. Reg. § 1.881-3(a)(4). For example, the documented facts include that payments characterized as interest made after Date 3 by USCorp and other U.S. operating companies to FCorp 1 were treated as exempt from withholding pursuant to the U.S.-Country 3 Income Tax Treaty; if, under Treas. Reg. § 1.881-3(d), some or all of those payments should have been subject to withholding at a reduced but non-zero treaty rate, the reduction in withholding tax would very likely be treated by the Director as significant within the meaning of Treas. Reg. § 1.881-3(b)(2)(i). Similarly, it does not appear that the FCorp 1 advances occurred in the ordinary course of the active conduct of complementary or integrated trades or businesses engaged in by FCorp 1 and USCorp or the U.S. operating companies within the meaning of Treas. Reg. § 1.881-3(b)(2).

Other facts necessary for the Director to treat those advances as part of a financing arrangement in which FCorp 1's involvement is disregarded as a conduit entity are less well developed, however. Thus, for example, while it seems clear that with respect to the first category of FCorp 1 advances described by the Associate Area Counsel, FCorp 1 could not have made advances to USCorp and other U.S. operating companies without capital contributed to it by FCorp 3 immediately (or very shortly) beforehand, no transactions have been identified in which FCorp 3 received either capital contributions from FCorp 2 that may be treated as financing transactions under Treas. Reg. § 1.881-3, or non-equity advances from FCorp 2 or any other person. Further, there is no indication that any amounts were returned to FCorp3. Absent such factual development, it is not possible to determine whether, as in Treas. Reg. § 1.881-3(e), Example (5), it would be appropriate for the Director to consider treating FCorp 3 as a disregarded conduit entity in a conduit financing arrangement that includes FCorp 2 (or any other person) as the financing entity and USCorp and the U.S. operating companies as financed entities. Further development of the sources of FCorp 3's capital funding or borrowings, especially those factors specifically taken into account under Treas. Reg. § 1.881-3(b)(2), are necessary to evaluate whether the Director would be justified in considering such treatment.

We note especially that the repayment of advances by either USCorp or one of the U.S. operating companies to FCorp 1, whether or not immediately prior to the advance of those funds to another United States affiliate, is not an advance of money which may be treated as part of either a financing transaction or a financing arrangement. Accordingly, with respect to the FCorp 1 advances in all three categories described above, it will be necessary to develop facts about the source of funds used by FCorp 1 to make the prior advances to USCorp or the U.S. operating companies, in order to determine whether FCorp 1's funds were derived, during some or all of the taxable years in issue, through contemporaneous financing transactions with FCorp 3, FCorp 2, or another entity.

If further factual development indicates that unrelated lenders advanced funds to FCorp 2, which then contributed capital to FCorp 3 through capital contributions that cannot be treated as financing transactions, you may wish to determine whether the lender had knowledge, or reason to know, that the financing arrangement was 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.

Certain facts described above are particularly relevant to determining whether FCorp 1's activities in connection with advances to USCorp or the U.S. operating companies should be treated as "significant financing activities" within the meaning of Treas. Reg. § 1.881-3(b)(3). The facts described would support a conclusion by the Director that FCorp 1 satisfies the first requirement of the active risk management test described above (because its officers and employees appear to exercise management over, and actively conduct, its day-to-day operations, which arguably consist of the supervision, administration and financing for a substantial group of related persons). It is less clear, however, whether FCorp 1's officers and employees actively manage, on an ongoing basis, material market risks arising from such financing transactions as an integral part of the management of the intermediate entity's financial and capital requirements (including management of risks of currency and interest rate fluctuations) and management of the intermediate entity's short-term investments of working capital by entering into transactions with unrelated persons. Further facts should be developed to prove whether FCorp 1 meets, or fails to meet, this aspect of the active risk management test. Similarly, evidence should be sought to determine whether FCorp 1's participation in any financing arrangement produced, or could have been expected to produce, any efficiency saving, by reducing transaction costs and overhead or other fixed costs. The extent to which FCorp 2 employees also participated materially in the active management of FCorp 1 short-investment activities also should be developed more fully, in order to clarify the extent to which their involvement cannot be described as consistent with the exercise of general supervision and control over FCorp 1's policies.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We note that although throughout the years in issue, FCorp 1 received repayments of principal or interest with respect to outstanding prior advances and immediately (or shortly) thereafter advanced the funds to USCorp or another U.S. operating company, a transfer of money or other property in satisfaction of a repayment obligation is not an advance of money or other property within the meaning of Treas. Reg. § 1.881-3. [redacted] Nonetheless, the period of time between financing transactions is but one of four enumerated factors, which themselves are non-exclusive factors to be considered by the Director in determining whether to invoke Treas. Reg. § 1.881-3.

This advice does not consider whether the prior “advances” to FCorp 4 are properly characterized as debt or equity, or the consequences of their “repayment,” to FCorp 4 in Year 1, if they are properly treated as equity investments.

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Please call this office at (202) 622-3840 if you have any further questions.

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