SCOPE OF THE NEW U.S. CONDUIT FINANCING REGULATIONS AND THEIR IMPACT ON U.S. TAX TREATIES

Paul B Smith and Lee Crean[1]

The anticipated US conduit financing regulations were issued by the US Internal Revenue Service ("IRS") on 11th October 1994. They had been promised by the Omnibus Budget Reconciliation Act of 1993[2] and had been eagerly awaited by tax practitioners ever since - partly because of the wide impact such regulations might have on international financing arrangements and partly because various IRS officials had promised the regulations would be issued during the early summer months. While the issue of the regulations will undoubtedly cause a number of multinational groups to review their existing group financing arrangements, the new regulations will probably be greeted by most international tax practitioners with a sigh of relief.

The regulations, as issued, are only in proposed form and will not have effect until 30 days after they are issued in final form. Their scope is also much more restricted than practitioners had predicted. In particular, the regulations do not extend to equity investments[3] or to debt guarantees. The IRS and Treasury have, however, stated that they remain concerned about the potential for abuse with

---

1 Paul B Smith BSc, FCA, ATII is a Senior Tax Manager and Lee Crean MS, CPA is a Tax Manager with KPMG Peat Marwick, 1 Puddle Dock, Blackfriars, London EC4V 3PD. Tel: (0171) 311 8699/4974 Fax: (0171) 311 8342.

2 IRC §7701(l), introduced by OBRA 1993, granted the US Treasury the authority to prescribe regulations to recharacterize any multiple-party financing transaction as a transaction directly among two or more parties when it is determined that the recharacterization is appropriate to prevent the avoidance of US tax.

3 The IRS explanation of these regulations stated that, generally, investments in common stock (or investments in ordinary perpetual preferred stock) are excluded from the definition of financing transactions.

respect to such equity investments/debt guarantees and will "monitor developments" in this area. To use a journalist's terminology, "watch this space!"

In very broad terms, the regulations are intended to enable the IRS to recharacterize any multiple party financing transaction and to disregard one or more persons in a conduit financing arrangement for the purposes of imposing a liability for US withholding taxes. For example, if an intermediate company has been introduced into a financing arrangement in order to obtain a reduction in the normal rate of US withholding tax by taking advantage of a tax treaty and for no other business purposes, these regulations, when finalised could apply to deny the tax treaty benefit.

The IRS's position on conduit financing arrangements to date

Although the proposed regulations were only issued recently, the IRS has successfully challenged certain conduit financing arrangements from as long ago as 1972. In the US, the courts have held that certain transactions should be taxed by reference to the substance of the transaction as a whole.[4] This concept of "substance over form" is applied by the IRS with respect to numerous structures, not just in the "treaty shopping" context.

Intra-group financing arrangements

The IRS followed the above approach in *Aiken Industries, Inc. v Commissioner*,[5] where a US corporation borrowed funds from its Bahamian parent. The Bahamian parent then assigned this loan to a Honduran subsidiary in exchange for a note issued by the Honduran subsidiary to the Bahamian parent. The two notes had the same terms (i.e., principal amount, interest rate and payment schedules). The rationale for the structure was that the interest payments from the US subsidiary to the Honduran subsidiary would not be subject to US withholding tax due to the zero rate imposed on interest under Article IX of the US-Honduras income tax treaty.[6] As there is no income tax treaty between the US and the Bahamas, the original interest payments from the US to its Bahamian parent would have been subject to US tax at a rate of 30%. The Honduran company was obliged to pay to its Bahamian parent exactly what it collected. The IRS contended that the Honduran company was a conduit entity and, as such, had no substance. It had been established solely to avoid US withholding tax. Accordingly, the US Tax Court collapsed the two transactions. The Honduran conduit entity was ignored

---

4 See, e.g., *Commissioner v Court Holding Co*, 324 US 331 (1945).

5 56 TC 925 (1971), *acq. on another issue*, 1972-2 CB 1.

6 The convention between the US and Honduras was terminated on 31 December 1966. The interest payments before the Court in *Aiken* were made during 1965.

and the transactions were treated as a single loan by the Bahamian parent to its US subsidiary. US withholding tax was, therefore, imposed at the domestic rate of 30% on the interest payments.

The IRS has also addressed back-to-back loans using conduit entities located in favourable tax jurisdictions in both Rev. Rul. 84-152[7] and Rev. Rul. 84-153.[8] In neither of these cases were the terms of the loans identical as had been the situation in *Aiken*. While it was acknowledged in both of these rulings that some business or economic purpose existed for the financing transactions, the IRS considered that it could recharacterize the transactions because the intermediate entity did not have complete "dominion and control" over the interest received.

Rev. Rul. 84-152 involved a Swiss corporation which had wholly owned subsidiaries in the US and the Netherlands Antilles. The US corporation needed a significant increase in working capital. The Swiss parent loaned the Antilles subsidiary an amount approximating the funds needed by the US corporation at an interest rate of 10%. Shortly thereafter, the Antilles subsidiary reloaned the proceeds to the US corporation at an interest rate of 11%. The Antilles corporation would not have had sufficient funds to lend the US corporation without first obtaining the loan from its parent. The US corporation made timely interest payments to the Antilles corporation which, in turn, made timely interest payments to its Swiss parent.

Article VIII(1) of the 1948 US-Netherlands income tax treaty (Dutch Treaty) as it applied to the Antilles[9] provided generally that interest derived by an Antilles corporation from sources within the US would be exempt from tax in the US.[10] Article VII(1) of the US-Switzerland income tax treaty (Swiss Treaty), however, only reduces the rate of US withholding tax to 5% on interest derived by Swiss residents. Thus, by routing the financing through the Antilles, the group intended that the interest payments made by the US corporation should not be subject to US withholding tax. However, the IRS reasoned that the interest payments were not "derived ... by" the Antilles subsidiary as required by the interest article of the tax

7 1984-2 CB 381.

8 1984-2 CB 383.

9 The exemption from withholding tax on interest, as provided by the treaty extention to the Netherlands Antilles, still applies and will continue to apply under the 1992 income tax treaty by virtue of Article 37(4) of that treaty. The other provisions of the 1948 income tax treaty ceased to be effective as of 1st January 1988 following delivery by the United States of notices to the Netherlands to terminate the extension of the 1948 income tax treaty insofar as it applied to the Netherlands Antilles.

10 This exemption is, of course, subject to the various anti-abuse provisions in the treaty and will not apply if the Antilles corporation is engaged in a trade or business in the US through a permanent establishment.

treaty. In the view of the IRS, the words, "derived ... by" refer not merely to the obtaining of temporary possession of the interest paid, but to obtaining complete dominion and control over the interest payments. Citing *Aiken* as authority, the IRS collapsed the transactions and treated the interest as "derived ... by" the Swiss parent and not by the Antilles subsidiary. As such, the interest payments were subject to the 5% tax imposed by the Swiss Treaty.

In Rev. Rul. 84-153, a US corporation had both a wholly owned domestic subsidiary and an Antilles subsidiary. As in Rev. Rul. 84-152, the US subsidiary needed additional working capital. The US parent decided to obtain funding from non-US sources where interest rates were lower. In this case, the Antilles subsidiary issued bonds which were sold to foreign persons in public offerings outside of the US. The proceeds from the sale were lent to the US subsidiary. Again the IRS considered that the interest payments were not "derived ... by" the Antilles corporation because it lacked dominion and control over the payments. Accordingly, the IRS determined that the Antilles subsidiary was merely a conduit for the passage of the US subsidiary's interest payments to the foreign bondholders. As such, the interest payments were not subject to the zero rate of tax imposed by the Dutch Treaty but instead were governed by the jurisdictions where the bondholders were resident.

Back-to-back loans involving third-party banks

The IRS has also challenged back-to-back loan arrangements involving third party banks. In Rev. Rul. 87-89[11] a foreign corporation, organised in a country with which the US did not have an income tax treaty, had a wholly-owned US subsidiary. An unrelated bank was organised in a foreign country which had a zero rate of tax imposed on interest from the US. The foreign corporation deposited an amount with the bank. The bank lent the US corporation an amount less than the amount the foreign corporation had deposited. If the transactions were to be treated as independent, the interest payments made by the US corporation to the foreign bank would not be subject to US tax due to the zero rate contained in the treaty.

However, after analysing the facts, the IRS determined that the loan by the bank to the US corporation would not have been made or maintained on the same terms but for the foreign corporation's deposit of funds with the bank. This determination was made based on all of the facts and circumstances of the situation. In this case the transactions were determined to be interdependent and were treated as a direct loan from the foreign parent to its US subsidiary with the interest payments being subject to US withholding tax at the rate of 30%.

---

[11] 1987-2 CB 195.

Back-to-back arrangements involving dividends

More recently the IRS issued technical advice memorandum (TAM) 9133004. This TAM addressed back-to-back loans with dividend payments and it represented a significant expansion of Rev. Ruls. 84-152 and 84-153. In this private ruling, a publicly traded Canadian corporation owned a Dutch subsidiary which owned 99.56% of a US subsidiary. The Dutch subsidiary was an international finance and holding company and is referred to below as the Dutch finance company.

The Canadian parent purchased convertible debentures from the Dutch finance company and also made a contribution to the capital of the Dutch company. On the same day, the Dutch finance company made two ten-year term loans to its US subsidiary. The US corporation made interest payments on these loans and did not withhold US tax, relying on the zero-rate provided in the Dutch Treaty. During the same year, the Dutch finance company paid a dividend to its Canadian parent. This dividend consisted of more than 99% of the cash amount of interest received from the US company during the year.

The IRS considered that the interest paid by the US company was subject to US withholding tax under the US-Canada income tax treaty, as if the payments had been made directly to the Canadian parent. The taxpayer argued that the Dutch company had exclusive control over the receipts and nothing in its corporate charter required the dividend payment. Furthermore, it was argued that there was, in fact, a good business reason for setting up the Dutch finance subsidiary. The IRS contended that the Dutch finance subsidiary was no less of a conduit of funds because payments to its parent were in the form of dividends rather than interest. As such, the IRS concluded that the interest received by the Dutch company was never "paid to" the Dutch company because, based on the facts, the Dutch company never had dominion and control over the payments it received.

The Proposed Regulations

In General

In view of the positions taken by the IRS in the above rulings some commentators have commented that the new proposed regulations merely act to "codify" the IRS's administrative positions in the revenue rulings. In fact, these new regulations do not go as far as the case discussed above in TAM 9133004. However, unlike the *Aiken* case or the above rulings that attempted to interpret the relevant treaty by considering which party had "dominion and control" of the interest and therefore whether the interest payments were "derived ... by" the intermediate company, the new regulations fail to address these issues.

In general, the proposed regulations provide rules for determining whether the participation of an intermediate entity in a financing arrangement is pursuant to a plan which is designed to avoid US withholding taxes (specifically, US tax imposed on the income of foreign corporations which is not effectively connected to a US trade or business). These rules permit the IRS to disregard the participation of one or more persons in a financing arrangement if it is determined that an intermediate entity is a "conduit entity".

A "conduit entity" is an intermediate entity whose participation in a "financing arrangement" is disregarded in whole or in part pursuant to these regulations.[12]

A "financing arrangement" is defined in the regulations as two or more financing transactions pursuant to which one person (the financing entity) advances money or other property to another person (the intermediate entity) and the intermediate entity advances money or other property to a third person (the financed entity) and, if there is more than one intermediate entity, there is a chain of "financing transactions" linking each intermediate entity.[13]

A "financing transaction" includes any advance of money or property in exchange for debt, a lease or licence, etc.

As mentioned earlier in this article, these rules do not apply to exchanges for common stock or ordinary perpetual preferred stock. However, an exchange for certain instruments, which are treated as equity for US tax purposes, will be covered by these regulations if the instruments provide for normal creditors' rights. This would include stock which has rights attached to it or instruments where the repayment of the principal amount is ensured since these characteristics are indicia of debt rather than equity.

Conduit Determination

Certain standards are applied in determining whether an intermediate entity (or entities) is/are treated as a conduit entity (or entities). If the intermediate entity is related to the financing or financed entity it will be considered a conduit if the following two conditions are met:

1) If the participation of the intermediate entity reduces the US tax imposed under IRC §881;[14] and

---

12 Prop Reg §1.881-3(a)(2)(iii).

13 Prop Reg 1.881-3(2)(i).

14 Prop Reg §1.881-3(a)(4)(i)(A).

2) If the participation of the intermediate entity is pursuant to a tax avoidance plan.[15]

If the intermediate entity is not related to either the financing or financed entity an additional requirement must be met before it is considered to be a conduit entity. This requirement is that the intermediate entity would not have entered into the arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.[16]

Probably the most troubling aspect of this requirement is that if the financing entity guarantees the debt of the financed entity there is an automatic presumption that the intermediate entity would not have entered into the transaction on substantially the same terms.[17] This presumption, however, is rebuttable by the taxpayer by producing clear and convincing evidence to the contrary. Therefore, if a foreign parent company guarantees a loan made by a commercial bank to one of its US subsidiaries, the above presumption is made and the taxpayer has the burden of proof in rebutting it.

Tax Avoidance Plan

The determination of whether the participation of the intermediate entity in the financing arrangement is pursuant to a plan, one of the principal purposes of which is the avoidance of tax, is to be based on all the facts and circumstances. However, the only relevant purposes are those relating to the participation of the intermediate entity in the financing arrangement, not those relating to the existence of the financing arrangement in general.[18]

Factors to be taken into account in determining whether the participation of the intermediate entity is pursuant to a tax avoidance plan include:[19]

a) Whether the participation of the intermediate entity significantly reduces the tax which would otherwise be imposed under IRC §881. It is worth noting that the fact that an intermediate entity has a income tax treaty with the US is not sufficient by itself to establish a tax avoidance motive.

---

15 Prop Reg §1.881-3(a)(4)(i)(B).

16 Prop Reg §1.881-3(a)(4)(i)(C)(2).

17 Prop Reg §1.881-3(b).

18 Prop Reg 1.881-3(c)(1).

19 Prop Reg §1.881-3(c)(2).

b) Whether the intermediate entity would have been able to advance the money or other property to the financed entity without the advance of money or other property from the financing entity.

c) The length of time that separates the transactions between the financing entity and the intermediate entity and between the intermediate entity and the financed entity. A short period of time is an indication of a tax avoidance plan, while a long period of time is not.

d) If the intermediate entity is related to the financed entity, whether the two entities enter into a financing transaction to finance a trade or business activity engaged in by the financed entity which is part of, or complementary to, a substantial trade or business activity (other than, broadly, the making and managing of investments) engaged in by the intermediate entity. A financing transaction of this type is indicative that no tax avoidance plan exists.

In addition, it is presumed that the participation of an intermediate entity or entities is not pursuant to a tax avoidance plan if the intermediate entity is related to the financing and/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.[20]

A special rule applies where the financing entity is unrelated to both the intermediate entity and the financed entity. In this case it is presumed that the financing arrangement is not pursuant to a tax avoidance plan provided the intermediate entity is actively engaged in a substantial trade or business (other than, broadly, the making and managing of investments).[21]

Amount Recharacterized

The regulations also provide rules to determine the portion of each payment made by the financed entity which is to be recharacterized. The recharacterized portion is the portion of the payment that is equal to the ratio (not to exceed 1:1) of the average principal amount of such financing transaction(s) between the conduit entity and the financing entity to the average principal amount of such transaction(s) between the financed entity and the conduit entity, for the period to which the payment made by the financed entity relates.[22]

---

20 Prop Reg 1-881-3(c)(3).

21 Prop Reg §1.881-3(c)(4).

22 Prop Reg §1.881-3(d)(1)(i).

Impact on US income tax treaties

The regulations state:

> "A financing arrangement shall be subject to recharacterization under this section regardless of whether a conduit entity is a resident of a country that has an income tax treaty with the United States."[23]

This is a bold statement and one which is likely to conflict with tax treaties in certain circumstances. In the authors' view, in order to avoid a conflict with tax treaties, the following two-stage approach developed in the *Aiken* case and in subsequent revenue rulings should have been adopted by the regulations:

1. Can the intermediate company claim benefit of a tax treaty with the US?

   Does the intermediate entity have "dominion and control" over the interest income it receives and, consequently is the income "derived ... by" it as required by the relevant interest article of the treaty? If it has dominion and control so that it satisfies the "derived ... by" requirement, the intermediate company should be entitled to tax treaty benefits UNLESS the tax treaty contains a relevant limitation of treaty benefits article, or a specific limitation in the interest article of the treaty restricting the application to, typically, bona fide commercial arrangements.

2. Only if the intermediate company is unable to claim benefit of a tax treaty with the US for the reasons described above should the IRS then apply its 'substance over form' criteria to determine whether the financing arrangement should be viewed as though it ignored the presence of the intermediate company. The new regulations adequately address this test but ignore the treaty tests described above.

In many cases the tax treaty will include some form of treaty-shopping provision or limitation of treaty benefits article that will, effectively, enable the new regulations to be applied without conflict. Similarly, there will be other cases where the facts are such that the intermediate company is unable to demonstrate that it has dominion and control over the income received. In these circumstances it is again at least arguable by the IRS that the intermediate entity should not be entitled to claim tax treaty benefits. In such cases there will also be no conflict between tax treaties and the new regulations.

However, there will undoubtedly be other cases where the intermediate entity should be entitled to claim tax treaty benefits. Assume, for example that a Dutch

---

[23] Prop Reg §1.881-3(d)(3).

company is an intermediate company in a financing arrangement and that under the conduit financing regulations as currently proposed it is treated as a conduit entity and therefore to be ignored for the purposes of imposing US withholding tax. Assume also that the the Dutch company satisfies the limitation of tax treaty benefits provisions in article 26 of the 1992 US-Netherlands tax treaty and that it is entitled to benefits of the treaty. There is a conflict between US domestic law and a US tax treaty. Having satisfied the detailed requirements of the limitation of treaty benefits article, there would be a presumption that the Dutch company was not formed purely for tax motivated reasons. Nevertheless, should the above statement in the regulations require the treaty to be overridden and its benefits denied? The view of the authors is that, in these circumstances, the tax treaty should prevail and its benefits should be available. This is, however, an uncertain area of law in the United States.

The US Supreme Court issued a series of decisions between 1870 and 1890 that established the doctrine giving equal weight of authority to tax treaties and to US statutes and subjecting them to a rule of chronological precedence. In the 1870 Supreme Court case *The Cherokee Tobacco*,[24] the court made the following statement:

> "The effect of treaties and acts of Congress, when in conflict, is not settled by the Constitution. But the question is not involved in any doubt as to its proper solution. A treaty may supercede a prior act of Congress, and an act of Congress may supercede a prior treaty."

The above doctrine was followed by a series of Supreme Court cases over the following twenty years all of which reaffirmed the proposition that a treaty could be overriden by a subsequent statute.[25] The views of the Supreme Court were, however, tempered somewhat in later years when it subsequently established the principle that "[a] treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed".[26]

The proposed conduit financing regulations were issued under the authority provided by Congress in 1993 in IRC section 7701(l) which states:

---

24 78 US (11 Wall) 616 (1870).

25 See *The Head Money Cases*, 112 US 580 (1884); *Whitney v Robertson*, 124 US 190 (1888); *Botiller v Dominguez*, 130 US 238 (1889); *The Chinese Exclusion Case*, 130 US 581 (1889).

26 *Cook v United States*, 288 US 102 (1933) at 120.

> "The Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by this title."

When discussing the need for regulations in this area the Committee report to the 1993 Revenue Reconciliation Act makes it clear that Congress intended that the purpose of the regulations was to "prevent unwarranted avoidance of tax through multiple-party financial engineering, as well as to provide a mechanism for issuing additional guidance to taxpayers entering into financial transactions". It makes no reference, however, to any intention to override existing tax treaties.[27] In the absence of this clear intention, the authority of the IRS to issue regulations with the stated intention of overriding existing tax treaty obligations must be in doubt.

It remains to be seen whether these regulations are finalised in their present form and, if they are, whether they will be challenged in the courts on tax treaty principles. The message to be clearly drawn from these regulations is that the US government/IRS are unhappy with the ability of taxpayers to legitimately reduce US withholding taxes through the use of conduit financing arrangements. Multinational groups with such arrangements involving the US should, therefore, take this opportunity to review their existing and proposed financing arrangements in order to minimise the possibility of a future challenge from the IRS.

---

[27] This is in contrast to, for example, the US Foreign Investment in Real Property Tax Act of 1980 where section 1125(c) of the Act specifically provided for treaty override and this issue was agreed to by Congress and is referred to in the Conference Agreement to the House Bill.