

# The Anti-Conduit Rules

By Caroline H. Ngo

## I. Overview

In general, the anti-conduit regulations and related judicial doctrines provide rules that permit the Internal Revenue Service (the “Service”) to disregard, for purposes of Code Sec. 881, the participation of intermediate entities in a “financing arrangement” where such entities are acting as “conduit entities.” As discussed in more detail below, a “financing arrangement” is a series of transactions by which a financing entity advances money or other property to a financed entity if the advance and receipt by the financed entity are effected through one or more intermediate entities and there are financing transactions (*e.g.*, debt) linking the financing entity, each of the intermediate entities, and the financed entity.

An intermediate entity is a “conduit entity” (whose participation can be disregarded) only if the participation of the intermediate entity in the financing arrangement (i) reduces Code Sec. 881 Tax<sup>1</sup> (tax reduction effect test) *and* (ii) is pursuant to a tax avoidance plan of reducing Code Sec. 881 Tax (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).

To determine whether a financing arrangement has a tax reduction effect, the regulations require a comparison of the actual aggregate Code Sec. 881 Tax with the Code Sec. 881 Tax that would have *hypothetically* been imposed if the payments made by the financed entity were made *directly* to the financing entity. Thus, the tax avoidance test compares the hypothetical reduction of these limited types of taxes, rather than tax avoidance in general. The tax reduction effect test would not be met (and thus the intermediate entity is *not* a conduit entity) if no Code Sec. 881 Tax would be imposed on interest payments if they were hypothetically paid by the financed entity directly to the financing entity (because the intermediate entity is hypothetically a conduit entity). No Code Sec. 881 Tax would be imposed, for example, if a zero-percent withholding tax under an applicable income treaty or the portfolio interest exception would apply on such interest payments.

A tax avoidance plan is a plan in which one of the principal purposes is the avoidance of tax imposed by Code Sec. 881. In determining whether there is a tax avoidance plan, the Service will weigh all relevant evidence regarding the



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purposes for the intermediate entity's participation in the financing arrangement. The regulations set forth a non-exclusive list of factors to be considered, discussed further below.

If there is a financing arrangement that is effected through one or more conduit entities, the financing arrangement is recharacterized for purposes of Code Sec. 881 as an advance by the financing entity directly to the financed entity, resulting in additional tax under Code Sec. 881.

## II. More Detail

Reg. §1.881-3 was promulgated pursuant to the authority conferred on the Treasury Department by the enactment of Code Sec. 7701(l) in 1993.<sup>2</sup>

Reg. §1.881-3(a) provides that the director of field operations<sup>3</sup> has the authority to disregard, for purposes of Code Sec. 881, the participation of intermediate entities in a "financing arrangement" where such entities are acting as conduit entities. A "financing arrangement" is defined as a series of transactions by which a (1) "financing entity," (2) "advances money or other property," or grants rights to use property (3) to a "financed entity," (4) such advances are effected through "intermediate entities," and, (5) except in certain cases involving a related person, there are "financing transactions" linking the financing entity, each of the intermediate entities, and the financed entity.<sup>4</sup> A transfer of money or other property in satisfaction of a repayment obligation is not an advance of money or other property.<sup>5</sup> 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.<sup>6</sup> A financing transaction includes *inter alia* debt, certain debt-like stock, and any lease or license.<sup>7</sup>

The anti-conduit regulations provide a special rule for related parties. 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 of field operations may treat the related persons as a single intermediate entity if he 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.<sup>8</sup> This determination shall be based upon all of the facts and circumstances, including the enumerated factors considered in the tax avoidance plan test.<sup>9</sup>

If there is a financing arrangement, the director of field operations can treat the advance by the financing entity to the intermediate entity as if it were made directly to the financed entity. In order to do so, however, the director of field operations must first determine that the intermediate entity is "acting as a conduit entity."<sup>10</sup> In order for an "intermediate entity" to be acting as a "conduit entity," the director of field operations is required to apply two basic tests<sup>11</sup>: (i) the "tax reduction effect" test<sup>12</sup> and (ii) the "tax avoidance plan" test.<sup>13</sup> Both tests must be satisfied to treat an intermediate entity (alone or in combination with one or more related persons) as an intermediate entity that is "acting as a conduit entity." If either test is not satisfied with respect to a particular combination of "financing transactions" that might constitute a "financing arrangement," the director of field operations cannot treat the intermediate entity as a "conduit entity" under the anti-conduit regulations.

To determine whether a financing arrangement has a tax reduction effect, the regulations require a comparison of the actual aggregate Code Sec. 881 Tax with the Code Sec. 881 Tax that would have hypothetically been imposed if the payments made by the financed entity were made directly to the financing entity.<sup>14</sup> The tax reduction effect test would not be satisfied if the financing entity being tested would be exempt from Code Sec. 881 Tax on interest it would have received in respect of the financing arrangement being tested. The financing entity could be exempt from Code Sec. 881 Tax if it would be entitled to claim the portfolio interest exemption or the elimination of withholding tax under an applicable tax treaty (if the limitation on benefits article of the treaty between the countries of the financed entity and the financing entity is satisfied).<sup>15</sup>

Even if the tax reduction effect test is satisfied (because there is a tax reduction effect), the conduit financing arrangement test will still not be satisfied if the tax reduction is not the result of a tax avoidance plan. A tax avoidance plan is a plan in which one of the principal purposes is the avoidance of Code Sec. 881 Tax.<sup>16</sup> Avoidance of the Code Sec. 881 Tax may be one of the principal purposes for such a plan even though it is outweighed by other purposes (taken together or separately).<sup>17</sup> 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.<sup>18</sup> A tax avoidance plan may be formal or informal, written or oral, and may involve any one or more of the parties to the financing arrangement.<sup>19</sup> The tax avoidance plan must be in existence no later than the last date that any of the

financing transactions comprising the financing arrangement is entered into.<sup>20</sup> The director of field operations 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 of field operations will weigh all relevant evidence regarding the purposes for the intermediate entity's participation in the financing arrangement.<sup>21</sup>

The regulations set forth non-exclusive, enumerated factors that are 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 Code Sec. 881 Tax. The factors include (i) whether the participation of the intermediate entity (or entities) in the financing arrangement significantly reduces the Code Sec. 881 Tax that otherwise would have been imposed<sup>22</sup>; (ii) 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<sup>23</sup>; (iii) the length of the period of time that separates the advances of money or other property by the financing entity to the intermediate entity, and ultimately by the intermediate entity to the financed entity<sup>24</sup>; and (iv) if the parties to the financing transaction are related, 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.<sup>25</sup>

In addition, the regulations provide that it shall be presumed that the participation of an intermediate entity (or entities) in a financing arrangement is not pursuant to a tax avoidance plan if (1) the intermediate entity is related to either or both the financing entity or the financed entity and (2) the intermediate entity performs significant financing activities (as defined in the regulations) with respect to the financing transactions forming part of the financing arrangement to which it is a party.<sup>26</sup> However, this presumption may be rebutted if the director of field operations establishes that the participation of the

intermediate entity in the financing arrangement is pursuant to a tax avoidance plan.<sup>27</sup>

Each entity is tested with respect to its role in a putative financing arrangement.<sup>28</sup> A financing arrangement can be tested by including financing transactions by various entities, but the participation of each putative intermediate entity in the case of each financing transaction

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is tested to determine whether in fact it is acting in connection with a particular financing transaction to effect a reduction of Code Sec. 881 Tax. A tax avoidance plan with respect to a putative participant must exist in order for there to be a conduit financing arrangement, and the determination that a plan exists, even if merely presumed from various *indicia*, is necessary to the application of the conduit regulations to treat an entity as a financing entity (or as an intermediate entity if it is not the direct lender) to the financed entity.<sup>29</sup>

In addition, the courts and the Service have applied substance-over-form principles to disregard the use of intermediaries and conduits that were imposed for the avoidance of Federal income taxes. *See, e.g., Del Commercial Properties, Inc. v. Commissioner*<sup>30</sup> and *Gaw v. Commissioner*.<sup>31</sup> *See also Aiken Industries, Inc. v. Commissioner*.<sup>32</sup>

### III. Summary

The anti-conduit authorities provide significant flexibility such that financing transactions are respected.

#### ENDNOTES

<sup>1</sup> "Code Sec. 881 Tax" includes any tax imposed under Code Secs. 871, 1441, and 1442. *See* Reg. §1.881-3(a)(1) ("For purposes of this section, any reference to tax imposed and Code Sec. 881 includes, except as otherwise provided and as the context may require, a reference to tax imposed under Code Sec. 871 or 884(f)(1)(A) or required to be withheld under Code Sec. 1441 or 1442.").

<sup>2</sup> *See* T.D. 8611, 1995-2 CB 286 (Aug. 10, 1995) (Preamble Part B.1., rejecting comments to the effect that prior conduit rulings and decisions had been based on matching cash flows).

<sup>3</sup> T.D. 9562, IRB 2012-5, 339 (Dec. 9, 2011) changed references to "district director" to "director of field operations" to reflect recent changes in the Service's organizational structure.

<sup>4</sup> Reg. §1.881-3(a)(2)(i)(A).

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> Reg. §1.881-3(a)(2)(ii).

<sup>8</sup> Reg. §1.881-3(a)(2)(i)(B).

<sup>9</sup> *Id.*

<sup>10</sup> Reg. §1.881-3(a)(4)(i).

<sup>11</sup> As noted above, a third requirement for an intermediate entity to be a conduit entity is that

either (i) the intermediate entity is related to the financing entity or the financed entity; or (ii) 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. This note focuses on the first two tests.

<sup>12</sup> Reg. §1.881-3(a)(4)(i)(A).

<sup>13</sup> Reg. §1.881-3(a)(4)(i)(B) and 1.881-3(b).

<sup>14</sup> Reg. §1.881-3(a)(4)(i)(A).

<sup>15</sup> Potential paths to satisfaction of the limitation on benefits article include the public parent (and the sub-of-public parent) test, ownership/base erosion test, active trade or business test, and the derivative benefits test. *But see* Caroline H. Ngo, *Traps for the Unwary in Treaties*, INT'L TAX J., Jul.-Aug. 2022.

<sup>16</sup> Reg. §1.881-3(b)(1).

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> The determination of whether the participation of an intermediate entity significantly

reduces the tax generally is made by comparing the aggregate Code Sec. 881 Tax imposed on payments made on financing transactions making up the financing arrangement with the tax that would be imposed if the payments were recharacterized under Reg. §1.881-3(d). However, the taxpayer is not barred from presenting evidence that the financing entity, as determined by the director of field operations, 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. Reg. §1.881-3(b)(2)(i).

<sup>23</sup> In the case of multiple intermediate entities, the director of field operations will consider 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. Reg. §1.881-3(b)(2)(ii).

<sup>24</sup> 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. Reg. §1.881-3(b)(2)(iii).

<sup>25</sup> Reg. §1.881-3(b)(2)(iv).

<sup>26</sup> Reg. §1.881-3(b)(3).

<sup>27</sup> *Id.*

<sup>28</sup> Reg. §1.881-3(b)(1).

<sup>29</sup> Reg. §1.881-3(a)(4)(i)(B).

<sup>30</sup> 78 TCM 1183, Dec. 53,662(M), TC Memo. 1999-411, *aff'd*, CA-DC, 2001-2 USTC ¶150,474, 251 F3d 210 (2001), *cert. denied*, 2002 U.S. LEXIS 418 (2002).

<sup>31</sup> 70 TCM 1196, Dec. 50,989(M), TC Memo. 1995-531, *aff'd without published opinion*, CA-DC, 111 F3d 962 (1997).

<sup>32</sup> 56 TC 925, Dec. 30,912 (1971), *acq. on other issue*, 1972-2 CB 1; Rev. Rul. 84-152, 1984-2 CB 381, Rev. Rul. 84-153, 1984-2 CB 383 (both limited by Rev. Rul. 95-56, 1995-2 CB 322, following issuance of anti-conduit regulations); and TAM 9133004 (May 3, 1991).

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