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Jack Cummings
Editor

The Atlantic Building
950 F Street, NW
Washington, DC 20004-1404
202.756.3300
Fax: 202.756.3333

www.alston.com

IRS Issues Proposed Regulations Addressing Disregarded Entities and Solicits Comments on Hybrid Instruments

On December 19, 2008, the Internal Revenue Service (IRS) issued proposed regulations ("Proposed Regulations") that address the application of the conduit financing arrangement rules of Treas. Reg. § 1.881-3 to structures involving disregarded entities.

Overall, the Proposed Regulations provide much-needed clarification as to the proper treatment of disregarded entities under the conduit financing arrangement regulations and are effective for payments made on or after the date the regulations are adopted in final form.

Background

Under authority granted in Internal Revenue Code ("Code") § 7701(l), Treas. Reg. § 1.881-3, the IRS can disregard the participation of one or more intermediate entities acting as "conduit entities" in "financing arrangements" that are designed to avoid taxes. This rule allows the IRS to disregard the participation of an intermediate entity and to re-characterize a multiple-party "financing transaction" as a transaction directly between the parties on either side of the conduit entity for purposes of imposing tax under Section 871, 881, 1441 and 1442 of the Code.

Treas. Reg. § 1.881-3(a)(2)(i)(A) defines a financing arrangement as a series of financing transactions by which one person (the financing entity) advances funds to another person (the intermediate entity) that, in turn, advances funds to another person (the financed entity). Except for a special rule for related parties, the regulations apply only if financing transactions link the financing entity, each of the intermediate entities and the financed entity. Under Treas. Reg. § 1.881-3(a)(2)(ii), financing transactions include debt, 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), leases, licenses or other transactions in which a person advances property or grants rights to use property to a transferee who is obligated to return a substantial portion of the property advanced.

Under the "check-the-box" regulations in Treas. Reg. §§ 301.7701-1 through 301.7701-3, an eligible entity that isn't classified as a corporation and has a single owner may elect to be disregarded as an entity separate from its owner (a disregarded entity) for U.S. federal income tax purposes.

The Proposed Regulations

Disregarded Entities

Since the check-box-regulations were promulgated, some taxpayers have taken the position that there is uncertainty over the application of the conduit rules to structures that include a check-the-box disregarded entity. This perceived uncertainty resulted in some taxpayers arguing that the check-the-box election requires disregarding back-to-back financing arrangements so that the conduit regulations are inapplicable. A back-to-back loan; i.e., a loan between an entity in a non-tax-treaty country and a U.S. entity that is channeled through a subsidiary in a country that has a tax treaty with the United States could possibly allow the parties to profit from the treaty country subsidiary's tax treaty benefits. The anti-conduit regulations, however, disallow treaty benefits for treaty country conduit entities when those conduits are not considered the beneficial owner of the income. Under the check-the box rules and section 894, however, disregarded entities may still be entitled to claim treaty benefits. Some practitioners were using that provision to effectuate back-to-back loan arrangements, possibly reducing, even to zero, the withholding tax required, while sidestepping the anti-conduit regulations. The IRS has now issued the proposed regulations to resolve any uncertainty about the proper treatment of disregarded entities under the regulations.

Section 1.881-3(a)(2)(i)(C) of the proposed regulations provides that, for purposes of the rules on conduit financing arrangements, the term "person" would include a business entity that was disregarded as an entity separate from its single member owner. Because a disregarded entity is a "person," any transaction that it enters into will be taken into account for purposes of determining whether a conduit financing arrangement exists. Therefore, the intermediate disregarded entity under the check-the-box regulations is "regarded" for purposes of possibly disregarding the entity under the conduit financing regulations and re-characterizing the multiple-party "financing transaction" as a transaction directly between the parties on either side of the conduit entity.

Hybrid Instruments

The Treasury Department and the IRS are continuing to study conduit financing arrangements and may issue separate guidance on the treatment of hybrid instruments. Specifically, they are studying transactions in which a financing entity advances property to an intermediate entity in exchange for a hybrid instrument that is treated as debt under the laws of the foreign jurisdiction where the intermediate entity is a resident, but is treated as equity for U.S. federal tax purposes. The issue under consideration is whether the conduit financing regulations should apply to such instruments.

Two possible options of treating these instruments are discussed in the Proposed Regulations. One option is to treat all transactions involving hybrid instruments as financing transactions subject to the anti-conduit rules. The other option expands the factors to consider in determining when stock in a corporation (or other similar interest in a partnership or trust) constitutes a financing arrangement under Treas. Reg. §1.881-3(a)(2)(ii)(B). The Treasury and the IRS have proposed the following additional factors that would indicate the presence of a financing transaction:

- **the intent of the parties to pay all or substantially all payments received by the intermediate entity to the financing entity;**
- **the history of payments received by the intermediate entity to the financing entity; and**
- **the precedence of the obligees over other creditors on the payment of interest and principal, currently or in bankruptcy.**

The IRS requests comments on the first approach, including whether and to what extent a connection or relationship between the issuer and recipient of the hybrid instrument (e.g., an equity ownership percentage) should be required. The IRS also seeks comments on the listed factors approach, as well as on other possible approaches or factors that the IRS should consider when expanding the conduit financing regulations.

The Preamble cautions that no inference should be drawn from the approaches to hybrid instruments described in the Preamble regarding the treatment of such instruments under current law, including judicial doctrines with respect to conduit financing arrangements.

For additional information, please contact Tola Ozim at 212.210.9533 or Edward Tanenbaum at 212.210.9425.

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International Tax Group

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481

Edward Tanenbaum
Co-Chair
212.210.9425

John F. Baron
704.444.1434

Henry J. Birnkrant
202.756.3319

Robert T. Cole
202.756.3306

Philip C. Cook
404.881.7491

James E. Croker, Jr.
202.756.3309

Jasper L. Cummings, Jr.
919.862.2302

Eva Farkas-DiNardo
212.210.9592

Tim L. Fallaw
404.881.7836

Terence J. Greene
404.881.7493

Brian D. Harvel
404.881.4491

Michelle M. Henkel
404.881.7633

L. Andrew Immerman
404.881.7532

Brian E. Lebowitz
202.756.3394

Clay A. Littlefield
704.444.1440

Timothy J. Peaden
404.881.7475

Matthew A. Stevens
202.756.3553

Gerald V. Thomas II
404.881.4716

Diana Wessells
202.756.3389

Charles W. Wheeler
202.756.3308