

US Inbound Newsalert

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IRS issues final anti-conduit regulations on the treatment of disregarded entities

On December 8, 2011, the Internal Revenue Service (the "IRS") and Treasury Department (the "Treasury") issued final regulations relating to multiple-party financing arrangements that are effected through disregarded entities (T.D. 9562). These regulations, which finalize regulations issued in proposed form on December 22, 2008 (REG-113462-08), treat an entity disregarded as separate from its owner (a "disregarded entity") as a separate person for purposes of determining whether a conduit financing arrangement exists under Section 7701(l) of the Internal Revenue Code and Treasury Regulation section 1.881-3.

Final regulations make minor changes to proposed regulations

The final regulations issued under Treasury Regulation section 1.881-3(a)(2)(i)(C) make minor changes to the proposed regulations. First, the final regulations clarify that they apply to payments made on or after December 8, 2011. Second, the final regulations make minor edits to Example 3, which deals with the participation of a disregarded intermediate entity in a series of financing transactions. These edits do not alter the conclusion of the example as set forth in the proposed regulation, which is that FS, the disregarded entity, is treated as a person under Treasury regulation section 1.881-3(a)(2)(i)(C) and therefore is an intermediate entity linked by financing transactions to other parties in a financing arrangement.



Observation: To the extent clients have structures in place that have relied on the classification of intermediate entities as disregarded for purposes of the anti-conduit rules, such structures should be revisited in light of the final regulations.

Final regulations do not address the treatment of hybrid instruments

It is worth noting that the final regulations do not address the treatment of "hybrid instruments", defined as "instruments treated as debt for foreign law purposes and equity for U.S. purposes", in the context of conduit financing arrangements. Although the preamble to the proposed regulations requested comments on whether such instruments should constitute *per se* "financing transactions" under Treasury Regulation section 1.881-3(a)(2)(ii)(A) and part of a "financing arrangement" within the meaning of Treasury Regulation section 1.881-3(a)(2)(i)(A), only one comment letter was received, which recommended that specific policy and administrative concerns regarding the use of disregarded entities in financing transactions could be better addressed by a more targeted rule. Citing a wide array of concerns raised, the IRS and Treasury have decided to continue to study the area and as a result, the final regulations do not provide specific guidance on the treatment of hybrid instruments.

Observation: With regard to structures or transactions involving hybrid instruments, it is possible that the IRS and Treasury may issue future guidance on the treatment of such instruments in the context of financing transactions.

Observation: It should also be noted that the proposed regulations provided that the treatment of a disregarded entity was a "clarification" of existing law. This "clarification" language, taken with the language in the final regulations stating that "[n]o inference should be drawn from any provision of these final regulations as to the treatment of financing transactions entered into with disregarded entities before the effective date of these final regulations or involving hybrid instruments", may suggest that the IRS and Treasury intend to treat a disregarded entity as a person for transactions or payments made prior to the effective date of the final regulations.

For more information, please do not hesitate to contact:

<i>Bernard Moens</i>	<i>(202) 414-4302</i>	<i>bernard.moens@us.pwc.com</i>
<i>Oren Penn</i>	<i>(202) 414-4393</i>	<i>oren.penn@us.pwc.com</i>
<i>Steve Nauheim</i>	<i>(202) 414-1524</i>	<i>stephen.a.nauheim@us.pwc.com</i>
<i>Alexandra Helou</i>	<i>(202) 346-5169</i>	<i>alexandra.k.helou@us.pwc.com</i>
<i>Phyllis Marcus</i>	<i>(202) 414-7565</i>	<i>phyllis.e.marcus@us.pwc.com</i>

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