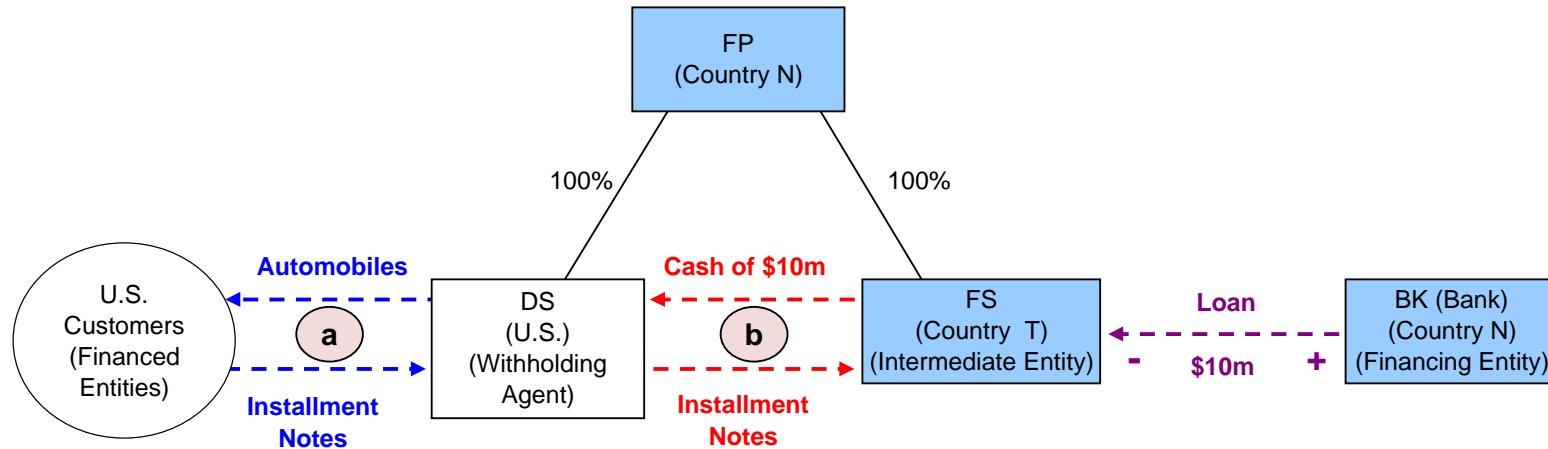


**Reg. 1.1441-7(f)(2)(ii),  
Example 1**

**Withholding Required For  
Conduit Financing Arrangement**

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DS is a U.S. subsidiary of FP, a corporation organized in Country N, a country that does not have an income tax treaty with the United States. FS is a special purpose subsidiary of FP that is incorporated in Country T, a country that has an income tax treaty with the United States that prohibits the imposition of withholding tax on payments of interest. FS is capitalized with \$10,000,000 in debt from BK, a Country N bank, and \$1,000,000 in capital from FP.

U.S. customers, purchase automobiles from DS in return for installment notes. DS sells the installment notes to FS in exchange for \$10,000,000. DS continues to service the installment notes for FS and the U.S. customers are not notified of the sale of their obligations and they continue to make payments to DS. But for the withholding tax on payments of interest by DS to BK, DS would have borrowed directly from BK, pledging the installment notes as collateral.

The installment notes are financing transactions, whether held by DS or by FS, and the FS note held by BK also is a financing transaction. After FS purchases the installment note, and during the time the installment note is held by FS, the transactions constitute a financing arrangement, within the meaning of Reg. 1.881-3(a)(2)(i). BK is the financing entity, FS is the intermediate entity, and the U.S. customers are the financed entity. Because the participation of FS in the financing arrangement reduces the tax imposed by section 881 and because there was a tax avoidance plan, FS is a conduit entity.

Because the U.S. customers do not know or have reason to know of the tax avoidance plan (and by extension that the financing arrangement is a conduit financing arrangement), the U.S. customers are not required to withhold tax under section 1441. However, DS, who knows that FS's participation in the financing arrangement is pursuant to a tax avoidance plan and is a withholding agent for purposes of section 1441, is not relieved of its withholding responsibilities.

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