FP, a corporation organized in country N, owns all of the stock of FS, a corporation organized in country T, and DS, a corporation organized in the United States. Country T, but not country N, has an income tax treaty with the United States. The treaty exempts interest, rents and royalties paid by a resident of one state (the source state) to a resident of the other state from tax in the source state.

On January 1, 1995, FP lends $10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes $10,000,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock of FS2. On January 1, 1996, FS2 lends $10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company whose most significant asset is the stock of FS2. Throughout the period that the FP-FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP-FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP-FS loan. One of the principal purposes for the absence of a financing transaction between FS and FS2 is to avoid being treated as a conduit financing arrangement.

The transactions described above would form a financing arrangement but for the absence of a financing transaction between FS and FS2. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of an entity as a conduit, the district director may treat the financing transactions between FP and FS, and between FS2 and DS as a financing arrangement. In such a case, FS and FS2 would be considered a single intermediate entity for purposes of this section.