MODIFICATION OF DEBT INSTRUMENTS

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Brady Cox
Jackson Walker L.L.P.
2323 Ross Ave., Suite 600
Dallas, Texas 75182
214-953-5831
bcox@jw.com

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U.S. FEDERAL INCOME TAX ISSUES WITH DEBT MODIFICATIONS

A. Background.

1. Recognition of Gain or Loss on Sale or Exchange of Property. Section 1001(c) of the Code provides that generally, "the entire amount of the gain or loss on the sale or exchange of property shall be recognized." Section 1001(a) of the Internal Revenue Code of 1986, as amended (the "Code"), provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis, and the loss is the excess of the adjusted basis over the amount realized. Treas. Reg. § 1.1001-1(a) provides that "the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."

2. U.S. Supreme Court Decision in *Cottage Savings v. Commissioner*. In *Cottage Savings v. Commissioner*,[1] the U.S. Supreme Court held that a financial institution that exchanged its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans in an arms-length commercial transaction resulted in gain or loss recognition under Section 1001 of the Code because the exchanged assets were materially different under Treas. Reg. § 1.1001-1(a). The Court stated that properties are "different" in the sense that is "material" to the Code so long as their respective "possessors enjoy legal entitlements that are different in kind or extent."[2] The Court held that because the mortgage loans were made to different obligors and secured by different homes, they embodied distinct legal entitlements, and therefore, the taxpayer realized losses when it exchanged interests in the loans.[3]

3. Service Issues Proposed Regulations in Response to Questions Raised by the Supreme Court's Decision in Cottage Savings. The *Cottage Savings* case did not involve the modification of an instrument, but an actual exchange between holders. Questions arose, however, concerning the Supreme Court's interpretation of the material difference standard and its possible application to modifications of debt instruments by issuers and holders.[4] The Internal Revenue Service recognized that uncertainty existed "with respect to whether particular types of modifications result in deemed exchanges of debt instruments. This uncertainty has resulted in a great deal of controversy between taxpayers and the Service and has produced a substantial body of administrative and judicial precedents."[5] In response to the issues raised by the *Cottage Savings* decision, and in an effort to provide certainty, on December 2, 1992, the Service issued Proposed Regulation Section 1.1001-3 under section 1001 of the Code to deal explicitly with the modification of debt instruments and to define when a modification will be deemed to be an exchange of the original instrument for a modified instrument that differs materially either in kind or in extent.[6] The regulations were finalized on June 25, 1996.[7]

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1 499 U.S. 554 (1991).
2 *Cottage Savings* at 564-65.
3 *Id.* at 556.
4 Notice of Proposed Rulemaking FI-31-92, 57 Fed. Reg. 57034, 57034 (1992), *reprinted in* 92 TNT 240-10.
5 *Id.*.
6 Notice of Proposed Rulemaking FI-31-92, 57 Fed. Reg. 57034, 57034 (1992).
7 T.D. 8675, 1996-2 C.B. 60, 70.

B. Debt Modification Regulations. Treas. Reg. § 1.1001-3 provides rules for determining whether a modification of the terms of a debt instrument results in an exchange.[8] In general, § 1.1001-3 employs a significant modification standard to determine whether modifications to a debt instrument in any form are sufficiently significant to cause the debt instrument to be treated as reissued or exchanged for purposes of § 1001. The application of Treas. Reg. § 1.1001-3 involves three steps:[9]

1. **Step One:** Determine Whether an Alteration of the Original Debt Instrument Constitutes a Modification of the Debt Instrument.

2. **Step Two:** If an Alteration of a Debt Instrument Constitutes a Significant Modification, Determine Whether the Modification is "Significant."

3. **Step Three:** If a Modification of a Debt Instrument is Significant, Determine the Federal Income Tax Consequences of the Deemed Exchange.

1. Relevant Terms. Below is a summary of relevant terms used in the debt modification regulations:

1. <u>Debt Instrument</u>: Any instrument or agreement that evidences indebtedness, including bonds, notes, debentures, and other similar instruments.

2. <u>Issuer</u>: The person that issued and is responsible for the obligations under the debt instrument, also known as the debtor.

3. <u>Holder</u>: The person that owns the debt instrument, also referred to as the creditor.

4. <u>Principal Amount</u>: The face amount of the debt instrument.

5. <u>Stated Interest Rate</u>: The rate of interest specified in the debt instrument.

6. <u>Yield</u>: The rate of return on a debt instrument.

2. Analysis of Step One -- Determine Whether an Alteration of the Debt Instruments Constitutes a "Modification". In applying Treas. Reg. § 1.1001-3, the first step is to determine whether an alteration of the original instrument constitutes a "modification." Section 1.1001-3 applies to any modification of a debt instrument, regardless of the form of the modification.[10] For example, it applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. It also applies to a modification

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[8] Treas. Reg. § 1.1001-3(a)(1).

[9] Notice of Proposed Rulemaking FI-31-92, 57 Fed. Reg. 57034, 57034 (1992); *cf.* Notice 2008-41, 2008-15 I.R.B. 742 ("Section 1.1001-3 applies to modifications in the form of amendments to the terms of an existing debt instrument and to modifications in the form of actual exchanges of existing debt instruments for different debt instruments. as defined in § 1.1001-3.").

[10] Treas. Reg. § 1.1001-3(a)(1).

of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. It, however, does not apply to exchanges of debt instruments between holders.[11]

a. Definition of Modification.

(1) General Rule. A modification generally means any alteration of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.[12] A modification includes any deletion or addition and may be evidenced by an express agreement (oral or written), conduct of the parties, or otherwise.

(2) Exception: **Alterations that Occur by Operation of the Original Terms of an Instrument Generally are Not Modifications**. Subject to the exceptions described below, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification.[13] An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.[14] However, the regulations limit the application of this exception and provide that the following alterations are modifications (and thus always must be tested for significance), even if these alterations occur by operation of the terms of a debt instrument:[15]

(A) Change in Obligor or Nature of Instrument. An alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification.[16]

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[11] Treas. Reg. § 1.1001-3(a)(1). For a special rule applicable to certain qualified tender bonds, *see* Treas. Reg. § 1.1001-3(a).

[12] Treas. Reg. § 1.1001-3(c)(1)(i); *cf.* CCA 199943037 (July 30, 1999) (The regulations view a refinancing as a modification of the old loan regardless of the form of the refinancing. If the modification is significant, the refinancing results in a taxable exchange in which the new loan is issued for the old loan and the old loan is retired."); Priv. Ltr. Rul. 9833015 (Aug. 14, 1998) ("The proposed modification of the Mortgage Note to permit the sale and release of a portion of the collateral securing the Mortgage Note alters the legal rights of the issuer and holder of the Mortgage Note and thereby effects a modification of the debt instrument under this regulation. The proposed modification, therefore, results in an exchange of the Mortgage Note if the proposed modification is a significant modification within the meaning of section 1.1001-3 of the regulations."). Although private letter rulings, technical advice memoranda, field service advice, and chief counsel advice are not binding as "precedent," they often represent a substantial indication of the position of the Service on an issue.

[13] Treas. Reg. § 1.1001-3(c)(1)(ii); *cf.* Priv. Ltr. Rul. 200047046 (Nov. 27, 2000) ("In the case of the Conduit Loans, the removal of Y as a co-conduit borrower on the Conduit Loans occurs by operation of the terms of the [Industrial Revenue Bonds] within the meaning of section 1.1001-3(c)(1)(ii).").

[14] Treas. Reg. § 1.1001-3(c)(1)(ii).

[15] Treas. Reg. § 1.1001-3(c)(2).

[16] Treas. Reg. § 1.1001-3(c)(2)(i); *cf.* Priv. Ltr. Rul. 200630002 (July 28, 2006) ("The Debt holders' legal rights against LLC with respect to payments and remedies will be the same legal rights that the Debt holders had against Parent. The obligations and covenants from LLC to the Debt holders will be the same as the obligations and covenants from Parent to the Debt holders. Since the Act specifically provides for the retention of the legal rights and obligations between

(B) Instrument That is Not Debt. An alteration that results in an instrument or property right that is not debt for federal income tax purposes is a modification unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer.[17]

(C) Certain Alterations Resulting From the Exercise of an Option. An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument is a modification unless—

1. The option is unilateral;[18] and

2. In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal.[19]

An option is unilateral only if, under the terms of an instrument or under applicable law:

1. There does not exist at the time the option is exercised, or as a result of the exercise, a right of the other party to alter or terminate the

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Parent (in the form of LLC) and the Debt holders, and since there were no legal rights or obligations between the Debt holders and New Parent prior to the restructuring, the restructuring cannot result in the creation of any new legal rights or obligations between the Debt holders and New Parent. * * * In these circumstances, the restructuring does not result in a change in the recourse nature of the Debt for purposes of section 1.1001-3(c)(2)(i). Further, the restructuring does not result in a significant modification of the Debt for purposes of section 1.1001-3(e) of the regulations."); Priv. Ltr. Rul. 200315001 (Apr. 11, 2003) (""The Debt holders' legal rights against LLC 1 with respect to payments and remedies will be the same legal rights that the Debt holders had against Parent. The obligations and covenants from LLC 1 to the Debt holders will be the same as the obligations and covenants from Parent to the Debt holders. Since the Act specifically provides for the retention of the legal rights and obligations between Parent (in the form of LLC 1) and the Debt holders, and since there were no legal rights or obligations between the Debt holders and New Parent prior to the restructuring, the restructuring cannot result in the creation of any new legal rights or obligations between the Debt holders and New Parent. * * * In these circumstances, the restructuring will not effect an alteration that results in either a change of obligor or a change in the recourse nature of the Debt for purposes of section 1.1001-3(c)(2)(i)."); Priv. Ltr. Rul. 200047046 (Nov. 27, 2000) ("Section 1.1001-3(f)(6)(i) provides that the obligor of tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. * * * X and Y are the co-conduit borrowers under the IRBs and, under section 1.1001-3(f)(6)(i), are not the obligors on the IRBs for purposes of section 1.1001-3. Therefore, the exception contained in section 1.1001-3(c)(2)(i) is inapplicable."); Priv. Ltr. Rul. 199904017 (Feb. 1, 1999) ("The notes of Y are unconditionally guaranteed by W and assumable by W. Y's assets consist of deposits with W and its affiliates, a small amount of real property, and stock in Z. Y serves only as a finance vehicle for W and its affiliates. Since W remains liable on the notes before and after the modification, the deletion of Y as a co-obligor does not result in a change in payment expectations. Thus, the assumption of the notes by W without any other change in terms does not constitute a significant modification under section 1.1001-3(e)(4)(iii).").

[17] Treas. Reg. § 1.1001-3(c)(2)(ii).

[18] Treas. Reg. § 1.1001-3(c)(2)(iii)(A); *see also* Treas. Reg. § 1.1001-3(c)(3) (definition of unilateral option); cf. Priv. Ltr. Rul. 201149017 (Dec. 9, 2011) ("The terms of the Bonds provide Taxpayer with the option to change interest rate periods and, if that option is exercised by Taxpayer, the Bonds shall be subject to mandatory tender by holders. The mandatory tender is not a right of the holders to alter or terminate the Bonds under section 1.1001-3(c)(3)(i). As a result, the Taxpayer's option to change interest rate periods is unilateral and the exercise of that option by Taxpayer is not a modification for purposes of section 1.1001-3.").

[19] Treas. Reg. § 1.1001-3(c)(1)(iii)(B).

instrument or put the instrument to a person who is related to the issuer;

2. The exercise of the option does not require the consent or approval of the other party, a person who is related to that party, whether or not that person is a party to the instrument; or a court or arbitrator; and

3. The exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a de minimis amount, a specified amount, or an amount that is based on a formula that uses objective financial information.[20]

Thus, under the foregoing rule, alterations resulting from the exercise of either of two categories of options are modifications. These two categories of options are (i) those that are not unilateral and (ii) holder option that result in a deferral or a reduction in any scheduled payment of interest or principal when exercised. The Preamble to the final regulations state that "Because alterations resulting from the exercise of such options typically involve either negotiations between an issuer and holder or a workout, the IRS and Treasury believe it is appropriate to treat them as modifications and test for significance."[21]

(3) Failure to Perform.

(A) General Rule. The failure of an issuer to perform its obligations under a debt instrument is generally not itself an alteration of a legal right or obligation and thus, not a modification.[22]

(B) Holder's Temporary Forbearance. Absent a written or oral agreement to alter other terms of the debt instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds (1) two years following the issuer's nonperformance; and (2) any additional period (after the initial two-year period) during which the parties conduct good faith negotiations or during which the issuer is in bankruptcy

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[20] Treas. Reg. § 1.1001-3(c)(2)(iii); *cf.* Priv. Ltr. Rul. 200321015 (May 23, 2003) ("Borrower holds a unilateral option to defease the Loan under applicable law where, as here represented by the taxpayer, the highest court of the State having jurisdiction over the real property and contractual obligations with respect to that property has held that a mortgagor has a right to obtain a release of a mortgagee's lien upon property if a mortgagor provides a mortgagee with the benefit of its bargain. * * * Accordingly, the tendering of the benefit of the mortgagee's bargain pursuant to the proposed plan of defeasance will not constitute a significant modification of the Loan within the meaning of §1.1001-3(c)(2)(iii)(A) of the regulations . . . ."); Priv. Ltr. Rul. 200047046 (Nov. 27, 2000) ("[T]he exception contained in section 1.1001-3(c)(2)(iii) is inapplicable because the removal of Y as co-conduit borrower does not give rise to a right to alter, terminate, or put the IRBs nor does it require consent or consideration.").

[21] T.D. 8675, 1996-2 C.B. 60, 62.

[22] Treas. Reg. § 1.1001-3(c)(4)(i).

proceedings.[23] Once the parties agree to new terms, however, there is a modification of the instrument.[24]

(C) Failure to Exercise an Option. If a party to a debt instrument has an option to change a term of an instrument, the failure of the party to exercise that option is not a modification.[25]

(4) Examples. Treas. Reg. § 1.1001-3(d) contains examples illustrating the operation of these rules.[26]

(A) ***Example (1):*** **Reset Bond.** A bond provides for the interest rate to be reset every 49 days through an auction by a remarketing agent. The reset of the interest rate occurs by operation of the terms of the bond and is not an alteration. Thus, the reset of the interest rate is not a modification.[27]

(B) ***Example (2):*** **Obligation to Maintain Collateral.** The original terms of a bond provide that the bond must be secured by a certain type of collateral having a specified value. The terms also require the issuer to substitute collateral if the value of the original collateral decreases. Any substitution of collateral that is required to maintain the value of the collateral occurs by operation of the terms of the bond and is not an alteration. Thus, such a substitution of collateral is not a modification.[28]

(C) ***Example (3):*** **Alteration Contingent on an Act of a Party.** The original terms of a bond provide that the interest rate is 9 percent. The terms also provide that, if the issuer files an effective registration statement covering the bonds with the Securities and Exchange Commission, the interest rate will decrease to 8 percent. If the issuer registers the bond, the resulting decrease in the interest rate occurs by operation of the terms of the bond and is not an alteration. Thus, such a decrease in the interest rate is not a modification.[29]

(D) ***Example (4):*** **Substitution of a New Obligor Occurring by Operation of the Terms of the Debt Instrument.** Under the original terms of a bond issued by a corporation, an acquirer of substantially all of the corporation's assets may assume the corporation's obligations under the bond. Substantially all of the corporation's assets are acquired by another corporation and the acquiring corporation becomes the new obligor on the bond. The substitution of a new obligor, even though it occurs by operation of the terms of the bond, is a modification.[30]

(E) ***Example (5):*** **Defeasance with Release of Covenants.** A corporation issues a 30-year, recourse bond. Under the terms of the bond, the corporation may secure a release of the financial and restrictive covenants by placing in trust

[23] Treas. Reg. § 1.1001-3(c)(4)(ii); T.D. 8675, 1996-2 C.B. 60, 62.
[24] T.D. 8675, 1996-2 C.B. 60, 62.
[25] Treas. Reg. § 1.1001-3(c)(5).
[26] Treas. Reg. § 1.1001-3(b).
[27] Treas. Reg. § 1.1001-3(d), *Example (1)*.
[28] Treas. Reg. § 1.1001-3(d), *Example (2)*.
[29] Treas. Reg. § 1.1001-3(d), *Example (3)*.
[30] Treas. Reg. § 1.1001-3(d), *Example (4)*.

government securities as collateral that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. The corporation remains obligated for all payments, including the contribution of additional securities to the trust if necessary to provide sufficient amounts to satisfy the payment obligations. The option to defease the bond is a unilateral option.[31] The alterations occur by operation of the terms of the debt instrument. Thus, such a release of the covenants is not a modification.[32]

(F) *Example (6):* **Legal Defeasance.** Under the terms of a recourse bond, the issuer may secure a release of the financial and restrictive covenants by placing in trust government securities that will provide interest and principal payments sufficient to satisfy all scheduled payments on the bond. Upon the creation of the trust, the issuer is released from any recourse liability on the bond and has no obligation to contribute additional securities to the trust if the trust funds are not sufficient to satisfy the scheduled payments on the bond. The release of the issuer is an alteration, and thus is a modification.[33]

(G) *Example (7):* **Exercise of an Option by a Holder that Reduces Amounts Payable.** A financial institution holds a residential mortgage. Under the original terms of the mortgage, the financial institution has an option to decrease the interest rate. The financial institution anticipates that, if market interest rates decline, it may exercise this option in lieu of the mortgagor refinancing with another lender. The financial institution exercises the option to reduce the interest rate. The exercise of the option results in a reduction in scheduled payments and is an alteration. Thus, the change in interest rate is a modification.[34]

(H) *Example (8):* **Conversion of Adjustable Rate to Fixed Rate Mortgage.** The original terms of a mortgage provide for a variable interest rate, reset annually based on the value of an objective index. Under the terms of the mortgage, the mortgagor may, upon the payment of a fee equal to a specified percentage of the outstanding principal amount of the mortgage, convert to a fixed rate of interest as determined based on the value of a second objective index. The exercise of the option does not require the consent or approval of any person or create a right of the holder to alter the terms of, or to put, the instrument.[35] Because the required consideration to exercise the option is a specified amount fixed on the issue date, the exercise of the option is unilateral. The conversion to a fixed rate of interest is not an alteration. Thus, the change in the type of interest rate occurs by operation of the terms of the instrument and is not a modification.[36]

(I) *Example (9):* **Holder's Option to Increase Interest Rate.** A corporation issues an 8-year note to a bank in exchange for cash. Under the terms of the note, the bank has the option to increase the rate of interest by a specified amount upon a certain decline in the corporation's credit rating. The bank's right to increase the interest rate is a unilateral option.[37] The credit rating of the corporation declines below the specified level. The bank

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[31] Treas. Reg. § 1.1001-3(d), *Example (5)(i)*.
[32] Treas. Reg. § 1.1001-3(d), *Example (5)(ii)*.
[33] Treas. Reg. § 1.1001-3(d), *Example (6)*.
[34] Treas. Reg. § 1.1001-3(d), *Example (7)(ii)*.
[35] Treas. Reg. § 1.1001-3(d), *Example (8)(i)*.
[36] Treas. Reg. § 1.1001-3(d), *Example (ii)*.
[37] Treas. Reg. § 1.1001-3(d), *Example (9)(i)*.

exercises its option to increase the rate of interest. The increase in the rate of interest occurs by operation of the terms of the note and does not result in a deferral or a reduction in the scheduled payments or any other alteration described. Thus, the change in interest rate is not a modification.[38]

(J) *Example (10):* **Issuer's Right to Defer Payment of Interest.** A corporation issues a 5-year note. Under the terms of the note, interest is payable annually at the rate of 10 percent. The corporation, however, has an option to defer any payment of interest until maturity. For any payments that are deferred, interest will compound at a rate of 12 percent. The exercise of the option, which results in the deferral of payments, does not result from the exercise of an option by the holder. The exercise of the option occurs by operation of the terms of the debt instrument and is not a modification.[39]

(K) *Example (11):* **Holder's Option to Grant Deferral of Payment.** A corporation issues a 10-year note to a bank in exchange for cash. Interest on the note is payable semi-annually. Under the terms of the note, the bank may grant the corporation the right to defer all or part of the interest payments. For any payments that are deferred, interest will compound at a rate 150 basis points greater than the stated rate of interest.[40] The corporation encounters financial difficulty and is unable to satisfy its obligations under the note. The bank exercises its option under the note and grants the corporation the right to defer payments. The exercise of the option results in a right of the corporation to defer scheduled payments and is not a unilateral option. Thus, the alteration is a modification.[41]

(L) *Example (12): A***lteration Requiring Consent.** The original terms of a bond include a provision that the issuer may extend the maturity of the bond with the consent of the holder. Because any extension pursuant to this term requires the consent of both parties, such an extension does not occur by the exercise of a unilateral option and is a modification.[42]

(M) *Example (13):* **Waiver of an Acceleration Clause.** Under the terms of a bond, if the issuer fails to make a scheduled payment, the full principal amount of the bond is due and payable immediately. Following the issuer's failure to make a scheduled payment, the holder temporarily waives its right to receive the full principal for a period ending one year from the date of the issuer's default to allow the issuer to obtain additional financial resources. The temporary waiver in this situation is not a modification. The result would be the same if the terms provided the holder with the right to demand the full principal amount upon the failure of the issuer to make a scheduled payment and, upon such a failure, the holder exercised that right and then waived the right to receive the payment for one year.[43]

[38] Treas. Reg. § 1.1001-3(d), *Example (9)(ii)*.
[39] Treas. Reg. § 1.1001-3(d), *Example (10)*.
[40] Treas. Reg. § 1.1001-3(d), *Example (11)(i)*.
[41] Treas. Reg. § 1.1001-3(d), *Example (11)(ii)*.
[42] Treas. Reg. § 1.1001-3(d), *Example (12)*.
[43] Treas. Reg. § 1.1001-3(d), *Example (13)*.

b. Time of Modification.

(1) General Rule. An agreement to change a term of a debt instrument is a modification at the time the issuer and holder enter into the agreement, even if the change in the term is not immediately effective.[44]

(2) Exceptions.

(A) Closing Conditions. If the parties condition a change in a term of a debt instrument on reasonable closing conditions (for example, shareholder, regulatory, or senior creditor approval, or additional financing), a modification occurs on the closing date of the agreement. Thus, if the reasonable closing conditions do not occur so that the change in the term does not become effective, a modification does not occur.[45]

(B) Bankruptcy Proceedings. If a change in a term of a debt instrument occurs pursuant to a plan of reorganization in a bankruptcy case, a modification occurs upon the effective date of the plan. Thus, unless the plan becomes effective, a modification does not occur.[46]

3. Analysis of Step Two: If an Alteration of a Debt Instrument Constitutes a Modification, Determine Whether the Modification is "Significant."

a. General Rule. If an alteration of a debt instrument constitutes a modification, the modification is then tested to determine whether it is a "significant modification." Treas. Reg. § 1.1001-3(b) provides that, for purposes of section 1.1001-1(a) of the regulations, a significant modification of a debt instrument results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent.[47] The regulations clarify that a modification that is not a significant modification is not an exchange.[48] Treas. Reg. §§ 1.1001-3(e) and (f) provide rules for determining whether the modification of a debt instrument is a significant modification.[49]

b. Significant Modifications. When determining if a modification is significant, the regulations provide specific tests that apply to certain types of modifications. When none of those specific tests apply, a general test, known as the General Significance Rule is used. The regulations clarify that Modification That is Not a Significant Modification is Not an Exchange.

(1) General Significance Rule. Treas. Reg. § 1.1001-3(e)(1) provides a general rule (the "General Significance Rule") for determining the significance of

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[44] Treas. Reg. § 1.1001-3(c)(6)(i).
[45] Treas. Reg. § 1.1001-3(c)(6)(ii).
[46] Treas. Reg. § 1.1001-3(c)(6)(iii).
[47] Treas. Reg. § 1.1001-3(b).
[48] Treas. Reg. § 1.1001-3(b); Notice of Proposed Rulemaking FI-31-92; 57 Fed. Reg. 57034, 57035 (1992); *see also* Rev. Proc. 2001-21, 2001-1 C.B. 742 (election whereby taxpayers can treat a substitution of debt instruments, in certain circumstances, as a realization event for federal income tax purposes even though its does not result in a significant modification for purposes of Section 1.1001-1(a)).
[49] Treas. Reg. § 1.1001-3(e). Treas. Reg. § 1.1001-3(b).

modifications not otherwise specifically addressed in Treas. Reg. §§ 1.1001-3(e)(2) through (e)(6), which provide specific rules for determining the significance of certain types of modifications and are discussed below. Under the General Significance Rule, a modification is a significant modification only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.[50] In making this determination, all modifications to the debt instrument (other than modifications subject to the specific rules described below) are considered collectively, so that a series of such modifications may be significant when considered together although each modification, if considered alone, would not be significant.[51]

(2) Specific Rules for Determining the Significance of Certain Types of Modifications. Treas. Reg. § 1.1001-3(e)(2) through (e)(6) set forth specific rules under which a modification is classified as a significant modification. The issue concerning whether a modification of any term is a significant modification is determined under each of these specific rules[52] and, if not specifically addressed in those rules, under the General Significance Rule. For example, a deferral of payments that changes the yield of a fixed rate debt instrument must be tested under both changes in yield and changes in timing of payments described below.[53]

(A) Change in Yield.[54] The change in yield rule applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to Treas. Reg. § 1.1272-1(c), debt instruments that provide for a fixed yield subject to §1.1272-1(d) (such as certain demand loans), and variable rate debt instruments. Whether a change in the yield of other debt instruments (for example, a contingent payment debt

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[50] Treas. Reg. § 1.1001-3(e); *cf.* Rev. Proc. 2008-51, 2008-35 I.R.B. 562 ("This revenue procedure describes circumstances in which the Internal Revenue Service ("Service") will not treat a debt instrument as an applicable high yield discount obligation ("AHYDO") for purposes of §§ 163(e)(5) and 163(i) of the Internal Revenue Code. * * * This revenue procedure provides certainty with respect to certain potential tax issues that may be implicated by the issuance of a debt instrument (including a deemed issuance of a debt instrument under § 1.1001-3 of the Income Tax Regulations) in the circumstances described below. No inference should be drawn about whether similar consequences would obtain if a debt instrument falls outside the limited scope of this revenue procedure. Furthermore, there should be no inference that, in the absence of this revenue procedure, a debt instrument within its scope would be an AHYDO."); Priv. Ltr. Rul. 9819043 (May 8, 1998) ("In the instant case, none of the proposed modifications falls within any of the specifically enumerated categories of significant modifications in the regulations. The first proposed modification, to make payments on the Notes in property other than money does not alter the legal rights or obligations of the parties to an economically significant degree. Obligor will recognize income or loss on the transfer of property to the Trust to the extent of the difference between the Obligor's adjusted basis in the property and the fair market value of the property. * * * However, it should be noted that whether a payment to a partner of an interest in a partnership can qualify as a payment on a Note may depend upon the facts and circumstances, and we express no opinion as to that question. * * * The second proposed modification of the Notes, the substitution of separate notes with identical terms in proportional amounts for an individual Note of the Obligor, similarly does not alter the legal rights and obligations of the parties to any economically significant degree. The holders' rights to payment on the smaller notes at the same interest rate applicable to the Note of the Obligor is effectively the economical equivalent of payment on the Note by the Obligor. * * * Finally, extension of the final maturity date on the Notes for a period of five years is a modification that falls within the safe harbor period of section 1.1001-3(e)(3)(ii) of the regulations.").

[51] Treas. Reg. § 1.1001-3(e)(1).

[52] *Cf.* Priv. Ltr. Rul. 9833015 (Aug. 14, 1998) ("Paragraph (f) of section 1.1001-3 of the regulations requires a determination whether a modification of any term is a significant modification under each applicable rule in paragraphs (e)(2) through (6) of section 1.1001-3. Paragraphs (e)(4) and (e)(2) are applicable to this case.").

[53] Treas. Reg. § 1.1001-3(f)(1)(i).

[54] Treas. Reg. § 1.1001-3(e).

instrument) is a significant modification is determined under the General Significance Rule.[55] The Preamble to the final regulations states that Treasury excluded other debt instruments from a bright line rule "[b]ecause of the difficulties in developing appropriate mechanisms for measuring changes in the yield of other debt instruments (for example, contingent payment debt instruments)."

A change in the yield of a debt instrument is a significant modification if the yield of the modified instrument (as computed below) varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of (a) 1/4 of one percent (25 basis points); or (b) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield).[56]

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[55] Treas. Reg. § 1.1001-3(e)(2)(i).

[56] Treas. Reg. § 1.1001-3(e)(2)(ii); *cf.* Priv. Ltr. Rul. 9833015 (Aug. 14, 1998) ("The Borrower represents that the yield on the Loan if modified as proposed to permit the sale and release of a portion of the collateral will not vary from the yield of the unmodified instrument by more than the greater of 25 basis points or 5 percent of the annual yield of the unmodified debt instrument."); Priv. Ltr. Rul. 201546009 (Nov. 13, 2015) ("In the instant case, the Consent Payment will result in the Noteholders receiving money to which they had not been previously entitled under the terms of the Indenture. Thus, the Consent Payment will be an alteration of the legal rights or obligations of the holders and issuer of the Notes, which is a modification under section 1.1001-3(c)(1)(i). * * * Because the Consent Payment will result in the holders of the Notes receiving more money than they otherwise would have under the terms of the Note, it will change the yield on the Notes. For debt instruments that are not contingent payment debt instruments, whether a change in yield results in a significant modification of a debt instrument is normally tested under the change in yield rule of section 1.1001-3(e)(2). However, because the Notes are contingent payment debt instruments, whether the Consent Payment results in a significant modification is instead tested under the general facts and circumstances test of section 1.1001-3(e)(1). Here, because the noncontingent bond method of accounting provides the Notes with interest that accrues by reference to a comparable yield and a projected payment schedule pursuant to section 1.1275-4(b), and the Consent Payment will result in a one-time payment to the holders of the Notes and will not otherwise alter the amounts that the holders of the Notes will receive, it is appropriate to apply a test similar to the change in yield test in section 1.1001-3(e)(2)."); Priv. Ltr. Rul 201431003 (Aug. 1, 2014) ("In the instant case, the Consent Payment will result in the Noteholders receiving money to which they had not been previously entitled under the terms of the Indenture. Thus, the Consent Payment will be an alteration of the legal rights or obligations of the holders and issuer of the Notes which is a modification under section 1.1001-3(c)(1)(i). * * * Because the Consent Payment will result in the holders of the Notes receiving more money than they otherwise would have under the terms of the Note, it will change the yield on the Notes. For debt instruments that are not contingent payment debt instruments, whether a change in yield results in a significant modification of a debt instrument is normally tested under the change in yield rule of section 1.1001-3(e)(2). However, because the Notes are contingent payment debt instruments, whether the Consent Payment results in a significant modification is instead tested under the general facts and circumstances test of section 1.1001-3(e)(1). Here, because the noncontingent bond method of accounting provides the Notes with interest that accrues by reference to a comparable yield and a projected payment schedule pursuant to section 1.1275-4(b), and the Consent Payment will result in a one-time payment to the holders of the Notes and will not otherwise alter the amounts that the holders of the Notes will receive, it is appropriate to apply a test similar to the change in yield test in section 1.1001-3(e)(2). Therefore, to determine whether the Consent Payment results in a significant modification within the meaning of the general facts and circumstances test of section 1.1001-3(e)(1), Taxpayer should compare the 'go-forward yield' to the 'original yield' of each outstanding Note. The 'go-forward yield' is the yield of a hypothetical debt instrument having (i) an issue date on the date the Notes are modified; (ii) an issue price equal to the adjusted issue price of the applicable Note as of that date, reduced by the amount of the Consent Payment; and (iii) a projected payment schedule consisting of the remaining payments on the applicable Notes original projected payment schedule. The 'original yield' is the comparable yield of each Note determined under section 1.1275-4(b)(4) as of the issue date of each Note. If the excess of the 'go-forward yield' over the 'original yield' is not more than 5 percent of the 'original yield,' the modification will not result in a significant modification within the meaning of section 1.1001-3(e)(1). * * * Under the noncontingent bond method in section 1.1275-4(b), payments received by a holder of contingent payment debt instrument are generally compared against the projected payment schedule. To the

(i) Computation of Yield of the Modified Instrument. The yield of the modified instrument is the annual yield of a debt instrument with (1) an issue price equal to the adjusted issue price of the unmodified instrument on the date of the modification (increased by any accrued but unpaid interest and decreased by any accrued bond issuance premium not yet taken into account, and increased or decreased, respectively, to reflect payments made to the issuer or to the holder as consideration for the modification); and (2) payments equal to the payments on the modified debt instrument from the date of the modification.[57] A commercially reasonable prepayment penalty for a pro rata prepayment[58] is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.[59]

The Preamble to the final regulations expressly states that Treasury did not adopt the suggestion of some commentators that a reduction in the principal amount of a debt instrument should not be considered a modification. Treasury's rationale for rejecting this suggestion was that "[a] reduction in principal reduces the total payments on the modified instrument and often results in a significantly reduced yield on the instrument. Thus, these rules give the same weight to changes in the principal amount as to changes in the interest payments. The IRS and Treasury believe that the tax consequences of a change in the yield that results from a change in the amounts payable should not differ because of the characterization of the payments that are reduced as principal rather than interest."

(ii) Variable Rate Debt Instruments. The annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument[60] which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.[61]

(B) Changes in Timing of Payments.

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extent payments exceed the amounts that had been projected, such payments are treated as a positive adjustment. To the extent payments are less than the amounts that had been projected, such payments are treated as a negative adjustment. Because the Consent Payment was not originally reflected on the projected payment schedule, it is akin to an amount received in respect of a projected payment of zero. Thus, it is a payment in excess of the projected payment and it is appropriate to treat it as a positive adjustment under section 1.1275-4(b)(6)(i). * * * To the extent the Consent Payment does not result in a significant modification under the test described above and any other modification made to the terms of the Notes does not individually result in a significant modification under section 1.1001-3(e)(6), such modifications will not collectively result in a significant modification of the Notes under section 1.1001-3(e)(1)."); Priv. Ltr. Rul. 201105016 (Feb. 4, 2011) ("In the instant case, the consent fees were paid to the Note holders as consideration for the modification of the Note indentures. Under section 1.1001- 3(e)(2)(iii), such fees are treated as payments on the Notes to determine whether there is a significant change in the yield on the Notes as a result of the payment.").

57 Treas. Reg. § 1.1001-3(e)(2)(iii)(A).

58 *See* Treas. Reg. § 1.1275-2(f)(2) (definition of pro rata prepayment).

59 Treas. Reg. § 1.1001-3(e)(2)(iii)(B); *cf.* Priv. Ltr. Rul. 9833015 (Aug. 14, 1998) ("[A]ll fees payable in connection with the release have been taken into consideration in computing the yield of the Loan as proposed to be modified. Because all fees payable in connection with the release, including an applicable prepayment penalty, have been taken into consideration in computing the yield of the modified instrument, a determination of whether the prepayment penalty is a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in section 1.1275-2(f)) within the meaning of section 1.1001-3(e)(2)(iii)(B) of the regulations is unnecessary.").

60 *See* Treas. Reg. § 1.1275-5(e) (definition of equivalent fixed rate debt instrument).

61 Treas. Reg. § 1.1001-3(e)(iv).

(i) General Rule. A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.[62]

(ii) Safe Harbor Period. The deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of five years or 50 percent of the original term of the instrument. The term of an instrument is determined without regard to any option to extend the original maturity and deferrals of *de minimis* payments are ignored. If the period during which payments are deferred is less than the full safe-harbor period, the unused portion of the period remains a safe-harbor period for any subsequent deferral of payments on the instrument.[63]

(C) Change in Obligor. Whether the substitution of a new obligor constitutes a significant modification depends on whether the debt instrument is recourse or nonrecourse. There are special rules for the addition or deletion of obligors, Section 338 elections and bankruptcy proceedings.

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[62] Treas. Reg. § 1.1001-3(e)(3)(i).

[63] Treas. Reg. § 1.1001-3(e)(3)(ii); *cf.* CCA 199943037 (Oct. 29, 1999) ("The modification of the old loan is significant because it results in the material deferral of scheduled payments. When the old loan is refinanced, the 75 percent portion of the stated principal amount that would otherwise be payable at maturity (after forgiveness) is reduced by an additional 15 percent and rescheduled into 120 monthly payments that begin after an additional two years. All of the payments due on the old loan are deferred for periods ranging from 2 to 12 years. This deferral significantly exceeds the deferral protected by the safe-harbor in the regulations, which is one and one-half years for loans under the old program. Therefore, the deferral is material, the modification is a significant modification, and the refinancing results in a taxable exchange for purposes of section 1001. Sections 1.1001-3(e)(3) and 1.1001-3(f)(1)."); F.S.A. 199928007 (July 16, 1999) ("The economic effect of paying the old loans with proceeds from the new loans (that have identical terms and conditions) was to extend the maturity date of the original loans. Thus, the issue is whether this was a material modification that would give rise to a realization event. Under section 1.1001-3(e)(3) a modification that changes the timing of payments due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. Under a safe-harbor rule in the regulations, the deferral of one or more scheduled payments within the safe-harbor period is not a material deferral if the deferred payments are unconditionally payable no later than at the end of the safe-harbor period. The safe-harbor period is the lesser of five years or 50 percent of the original term of the instrument. The old loans had a 5 year term and were replaced with new loans with the same term. Accordingly, these new loans would fall outside the safe harbor and must be treated as significant modifications to the old loans. Since the debt refinancing results in a realization event under section 1.1001-3, Taxpayer has realized and may deduct the currency losses at issue."); Priv. Ltr. Rul. 9819043 (May 8, 1998) ("Finally, extension of the final maturity date on the Notes for a period of five years is a modification that falls within the safe harbor period of section 1.1001-3(e)(3)(ii) of the regulations.").

(i) Substitution of a New Obligor on Recourse Debt Instruments. In general, except as provided below, the substitution of a new obligor on a recourse debt instrument is a significant modification.[64]

(ii) Exception: Section 381(a) Transactions. The substitution of a new obligor is not a significant modification if the acquiring corporation (within the meaning of section 381) becomes the new obligor pursuant to a transaction to which section 381(a) applies, the transaction does not result in a change in payment expectations, and the transaction (other than a reorganization within the meaning of section 368(a)(1)(F)) does not result in a significant alteration.[65]

(a) Exception: Certain Asset Acquisitions. The substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration.[66]

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[64] Treas. Reg. § 1.1001-3(e)(4)(i)(A); *cf.* Priv. Ltr. Rul. 200709013 (Mar. 2, 2007 ("Several steps of the Proposed Transaction involve the substitution of a new obligor on the Debt, resulting in a "modification" of the Debt within the meaning of section 1.1001-3(c)(2)(i). Under section 1.1001-3(e)(4)(i)(A) of the regulations, this modification is a significant modification except as provided in paragraphs (B), (C), or (D) of that section. In the present case, each step of the Proposed Transaction in which a new obligor is substituted will qualify for an exception under paragraph (B) or (C) of section 1.1001-3(e)(4)(i). Accordingly, the Proposed Transaction will not result in a significant modification of the Debt under section 1.1001-3(e) of the regulations.").

[65] Treas. Reg. § 1.1001-3(e)(4)(i)(B); *cf.* Priv. Ltr. Rul. 201010015 (Mar. 12, 2010) ("The Proposed Transactions will qualify as a reorganization pursuant to § section 368(a)(1)(D) of the Code. The conversion of Subsidiary 1 into LLC 6 will not involve the formation or merger of Subsidiary 1 with or into a new legal entity for State A law purposes. * * * After the completion of the Proposed Transactions, Parent will hold all of the membership interests in LLC 6, a limited liability company that will be disregarded as separate from its owner under § section 301.7701-3(b)(1)(ii) of the Procedural Regulations. In addition, immediately after the Proposed Transactions, the assets and liabilities of LLC 6 will be the same as the assets and liabilities of Subsidiary 1 immediately prior to the Proposed Transactions. * * * The Proposed Transactions will not (i) change the yield on the Debt (as computed under section 1.1001-3(e)(2)(iii)); (ii) change the specific timing of payments on the Debt; (iii) for State A law purposes, result in the addition or subtraction of co-obligors or guarantors to the Debt; (iv) change the priority of any of the Debt relative to other Debt; or (v) alter the legal rights or obligations with respect to the Debt. * * * Pursuant to the Act, none of Debt holders' rights against Subsidiary 1, including with respect to payments and remedies, and none of Subsidiary 1's obligations and covenants to Debt holders will be altered in any manner by the Proposed Transactions. Following the Proposed Transactions, Debt holders will continue to have the same legal relationship with LLC 6 that they previously had with Subsidiary 1, which is as general unsecured recourse claimants having no greater preference than any other creditor. Additionally, under State A law, the Proposed Transactions will not result in the creation of any new legal rights or obligations between Debt holders and Parent. There are no provisions in the original terms of Debt that require the consent or approval of any holder of any series of the Debt in order for Subsidiary 1 to effectuate the Proposed Transactions."); Priv. Ltr. Rul. 200447031 (Nov. 19, 2004) ("Based solely on the information submitted and the representations set forth above, and provided that the Mergers will constitute transactions to which § 381(a) applies and that Sub 1 and Sub 2 will constitute the acquiring corporations within the meaning of § 381, we rule as follows: (47) The substitution of Sub 1 for Controlled 1 and the substitution of Sub 2 for Controlled 2 as obligors on the Controlled 1 Securities and Controlled 2 Securities, respectively, will be transactions within the meaning of § 1.1001-3(e)(4)(i)(B).").

[66] Treas. Reg. § 1.1001-3(e)(4)(i)(C); *cf.* Priv. Ltr. Rul. 9711024 (Mar. 14, 1997) ("(2) Controlled's acquisition of all of Distributing's activities that constituted the Controlled Businesses and its assumptions of related liability (including the Notes) was an acquisition of substantially all of the assets, within the meaning of section 1.1001-3(e)(4)(i)(C), held by Distributing prior to the Distribution. (3) The Distribution and the substitution of Controlled for Distributing as obligor on the Notes will not result in a change in payment expectations with respect to the Notes within the meaning

(b) Tax-Exempt Bonds. The substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor (as defined in Section 168(h)(4)(A) and the collateral securing the instrument continues to include the original collateral.[67]

(c) Significant Alteration. For purposes of the above rules, a significant alteration is an alteration that would be a significant modification but for the fact that the alteration occurs by operation of the terms of the instrument.[68]

(iii) Substitution of a New Obligor on Nonrecourse Debt Instruments. The substitution of a new obligor on a nonrecourse debt instrument is not a significant modification.[69]

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of section 1.1001-3(e)(4)(i)(C) and (vi) as evidenced by Z's preliminary designation of W with respect to the Notes."). (4) The substitution of Controlled for Distributing as obligor on the Notes will not result in a significant alteration of the Notes within the meaning of section 1.1001-3(e). (5) Neither the addition of Controlled nor the subsequent release of Distributing as obligor on the Notes will constitute a sale or exchange within the meaning of section 1.1001-1(a).").

[67] Treas. Reg. § 1.1001-3(e)(4)(i)(D).

[68] Treas. Reg. § 1.1001-3(e)(4)(i)(E).

[69] Treas. Reg. § 1.1001-3(e)(4)(ii); cf. AM 2011-003(Aug. 26, 2011) ("Section 1001(a) provides that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain, and the loss shall be the excess of the adjusted basis over the amount realized. Section 1.1001-1(a) provides that gain or loss is realized from the exchange of property for other property differing materially either in kind or in extent. * * * Section 1.1001-3(b) provides that a debt instrument differs materially in kind or in extent if it has undergone a significant modification. Section 1.1001-3 applies to both actual exchanges of debt (e.g., a corporate issuer exchanges an existing debt instrument for a new debt instrument) and to amendments to existing debt instruments (e.g., an issuer seeks to alter the collateral that secures a debt instrument). Thus, an exchange of debt instruments, whether actual or deemed, is taxable only if the differences between the new and old debt constitute a significant modification. * * * Section 1.1001-3(c) provides rules for determining whether a change in the legal rights or obligations of a debt instrument is a modification. Pursuant to § 1.1001-3(c)(1)(i), a modification means any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument, whether the alteration is evidenced by an express agreement (oral or written), conduct of the parties, or otherwise. Section 1.1001-3(c)(1)(ii) provides that, except as provided in § 1.1001-3(c)(2), an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. Section 1.1001-3(c)(2)(i) provides that an alteration that results in the substitution of a new obligor, the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the debt instrument (from recourse to nonrecourse or from nonrecourse to recourse) is a modification, even if the alteration occurs by operation of the terms of a debt instrument. Section 1.1001-3(e) provides rules for determining whether a modification is significant. Section 1.1001-3(e)(4)(ii) provides that the substitution of a new obligor on a nonrecourse debt instrument is not a significant modification. Section 1.1001-3(e)(4) also provides that, except for certain exceptions, the substitution of a new obligor on a recourse debt instrument is a significant modification. One of these exceptions is set forth in § 1.1001-3(e)(4)(i)(C) and provides that the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration. A change in payment expectations occurs if either of the following occurs: (1) there is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was primarily speculative prior to the modification and is adequate after the modification; or (2) there is substantial impairment of the obligor's capacity to meet the payment obligations under the debt instrument that was adequate before the modification and is primarily speculative after the modification. Section 1.1001-3(e)(4)(vi). The preamble to final regulations under § 1001 further clarifies that "there is no change in payment expectations . . . if the obligor has at least an adequate capacity to meet its payment expectations both before and after the modification." T.D. 8675, 1996-2 C.B. 60, 63. A corporation's change in entity classification to a partnership under § 301.7701-3 results in a substitution of a new obligor under § 1.1001-3. However, even if a modification has occurred in Situations 1 and 2 because the partnership is treated as a new obligor, the

(iv) Addition or Deletion of Co-Obligor. The addition or deletion of a co-obligor on a debt instrument is a significant modification if the addition or deletion of the co-obligor results in a change in payment expectations. If the addition or deletion of a co-obligor is part of a transaction or series of related transactions that results in the substitution of a new obligor, however, the transaction is treated as a substitution of a new obligor (and is tested under the rules above rather than as an addition or deletion of a co-obligor).[70]

(v) Special Rules.

(a) Section 338 Election. An election under section 338 following a qualified stock purchase of an issuer's stock does not result in the substitution of a new obligor.[71]

(b) Bankruptcy Proceedings. The filing of a petition in a bankruptcy case by itself does not result in the substitution of a new obligor.[72]

(D) Change in Security or Credit Enhancement.

(i) Recourse Debt Instruments. A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on,

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modification will not be viewed as significant regardless of whether the liabilities are nonrecourse or recourse. With respect to nonrecourse debt, § 1.1001-3 clearly provides that a change in obligor is not a significant modification. With respect to recourse debt, § 1.1001-3(e)(4)(i)(C) provides that the substitution of a new obligor is not a significant modification if the new obligor acquires substantially all of the assets of the original obligor, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration. In Situations 1 and 2, the new obligor (the partnership) acquires substantially all of the insolvent corporation's assets and liabilities because, under § 301.7701-3(g)(1)(ii), Z is deemed to have distributed all its assets and liabilities to X and Y, who then contribute them to the newly formed partnership. In addition, though more factual development may be necessary, the change in entity classification from a corporation to a partnership is not likely to result in a change in payment expectations. Also, no significant alteration occurs as a result of the deemed liquidation in Situations 1 and 2. The deemed distribution of assets will not satisfy, in whole or in part, the $110 liability because under local law, Z's $110 liability to X in Situation 1 and to U in Situation 2 survives the deemed liquidation and continues in identical form as an obligation of Z, now operating in partnership form for federal tax purposes. As a result, neither recourse nor nonrecourse debt of the corporation would be treated as exchanged for new debt of the partnership based on the corporation's change in entity classification to a partnership under § 301.7701-3. The tax consequences of the insolvent corporation's debt with respect to an elective change under § 301.7701-3(c)(1)(i), as described above, are the same as the tax consequences that occur if Z actually liquidates, shareholders of Z immediately form a new partnership, Z's debt remains outstanding and unchanged under local law, and interest payments continue to be made on the debt following the entity change (i.e., Z's debt survives the liquidation and becomes an obligation of the partnership). Therefore, if Z had actually taken the steps described in § 301.7701-3(g)(1)(ii), neither recourse nor nonrecourse debt of Z would be treated as exchanged for new debt of the partnership under § 1.1001-3. In Situations 1 and 2, the analysis under § 1.1001-3 with respect to an actual liquidation applies equally to an insolvent corporation's debt owed to a shareholder/creditor and to an insolvent corporation's debt owed to a third-party creditor.").

[70] Treas. Reg. § 1.1001-3(e)(4)(iii); *cf.* Priv. Ltr. Rul. 9711024 (Mar. 14, 1997) ("The addition of Controlled as a co-obligor on the Notes on Date M and the proposed release of Distributing as co-obligor constitutes a series of related transactions that results in the substitution of a new obligor within the meaning of section 1.1001-3(e)(4)(iii).").

[71] Treas. Reg. § 1.1001-3(e)(4)(i)(F).

[72] Treas. Reg. § 1.1001-3(e)(4)(i)(G).

or other form of credit enhancement for a recourse debt instrument is a significant modification if the modification results in a change in payment expectations.[73]

(ii) Nonrecourse Debt Instruments. A modification that releases, substitutes, adds or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification.[74] A substitution of collateral is not a significant modification, however, if the collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and rating).[75] In addition, the substitution of a similar commercially available credit enhancement contract is not a significant modification, and an improvement to the property securing a nonrecourse debt instrument does not result in a significant modification.[76]

(E) Change in Priority of Debt. A change in the priority of a debt instrument relative to other debt of the issuer is a significant modification if it results in a change in payment expectations.[77]

(F) Change in Payment Expectations. A change in payment expectations occurs if, as a result of a transaction (i) there is a substantial enhancement of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity

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[73] Treas. Reg. § 1.1001-3(e)(4)(iv)(A).

[74] Treas. Reg. § 1.1001-3(e)(4)(iv)(B); *cf.* Priv. Ltr. Rul. 200047046 (Nov. 27, 2000) ("In the case of the ESOP loan and the TIRB, Y's earnings and assets will continue to provide payment capacity, even after Y's removal as co-obligor. The restrictions on Y's future debt issuance will ensure that the current co-obligations of X and Y will not be subordinated following the proposed removal of Y as co-obligor. Consequently, there would be no substantial alteration of the Guarantee or the Obligation and thus no 'significant modification' of the debt instruments."); Priv. Ltr. Rul. 9833015 (Aug. 14, 1998) ("The release of a portion of the collateral securing the Loan does not, however, release a substantial amount of the collateral within the meaning of the regulations if first, the amount paid for the release of the collateral, excluding any prepayment premium, is applied in its entirety to the outstanding balance of the Loan and the Loan continues to be secured by the remaining collateral; and second, the extent to which the remaining collateral secures the remaining debt after the modification does not differ to a significant degree, based on loan-to-value ratios, from the extent to which the total collateral secured the total debt before the modification. The proposed modification of the Mortgage Note satisfies these requirement and therefore does not constitute a significant modification under section 1.1001-3(e)(4)(iv)(B) of the regulations."); Priv. Ltr. Rul. 9801047 (Jan. 2, 1998) ("The proposed amendment of the Loan Agreement, by reducing the percentage of U.S. Government obligations required to [sic] be delivered to obtain a release of the entire mortgage lien, alters the legal rights of the issuer and holder of the Mortgage Loan and thereby effects a modification of the debt instrument under paragraph (c)(1) of section 1.1001-3 of the regulations. This reduction does not release, however, a substantial amount of the collateral for the Mortgage Loan under the specific circumstance in which the entire mortgage lien is released because, whether collateralized at 125 percent or at 100 percent, the obligation to repay the entire Mortgage Loan is fully and identically secured. Therefore, the proposed amendment of the Loan Agreement will not constitute a significant modification of the Mortgage Loan under paragraph (e)(4)(iv)(B) of section 1.1001-3, and will not result in an exchange of the original debt instrument for purposes of section 1.1001-1(a).").

[75] Treas. Reg. § 1.1001-3(e)(4)(iv)(B); *cf.* Priv. Ltr. Rul. 200648023 (Dec. 1, 2006) ("The proposed modification described above alters the legal rights of the issuer and holder of the Note and thereby effects a modification of the debt instrument under section 1.1001-3(c)(1)(i) of the regulations. However, because the proposed modification would only permit Borrower to substitute government securities for other government securities to be used as substitute collateral in a defeasance of the Loan, the proposed modification does not constitute a significant modification under section 1.1001-3(e)(4)(iv)(B) of the regulations.").

[76] Treas. Reg. § 1.1001-3(e)(4)(iv)(B).

[77] Treas. Reg. § 1.1001-3(e)(4)(v).

was primarily speculative prior to the modification and is adequate after the modification; or (ii) there is a substantial impairment of the obligor's capacity to meet the payment obligations under a debt instrument and that capacity was adequate prior to the modification and is primarily speculative after the modification.[78] The obligor's capacity includes any source for payment, including collateral, guarantees, or other credit enhancement.[79] The preamble to the regulations states that there is no change in payment expectations, however, if the obligor has at least an adequate capacity to meets its payment obligations both before and after the modification.[80]

(G) Changes in the Nature of a Debt Instrument.

(i) Property That Is Not Debt. Treas. Reg. § 1.1001-3(e)(5)(i) provides that a modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification. The determination of whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt for Federal income tax purposes shall take into account all of the factors relevant to such a determination. Deterioration in financial condition of the obligor generally disregarded. The policy behind § 1.1001-3(f)(7) is to encourage workouts when debtors have difficulty repaying their obligations to third-party creditors.[81]

(ii) Change in Recourse Nature.

(a) General Rule. Except as provided below, a change in the nature of a debt instrument from recourse (or substantially all recourse) to nonrecourse (or substantially all nonrecourse) is a significant modification. For example, a legal defeasance of a debt instrument in which the issuer is released from all liability to make payments on the debt instrument (including an obligation to contribute additional securities to a trust if necessary to provide sufficient funds to meet all scheduled payments on the instrument) is a significant modification. Similarly, a change in the nature of the debt instrument from nonrecourse (or substantially all nonrecourse) to recourse (or substantially all recourse) is a significant modification. If an instrument is not substantially all recourse or not substantially all nonrecourse either before or after a modification, the significance of the modification is determined under the General Significance Rule for determining significant modifications.[82]

(b) Exceptions.

(i) Original Collateral. A modification that changes a recourse debt instrument to a nonrecourse debt instrument is not a significant modification if the instrument continues to be secured only by the original collateral and the modification does not result in a change in payment expectations. For this purpose, if the original collateral is fungible or otherwise of a type where the particular units pledged are unimportant (for example, government securities or financial instruments of a particular type and

[78] Treas. Reg. § 1.1001-3(e)(4)(vi)(A).
[79] Treas. Reg. § 1.1001-3(e)(4)(vi)(B).
[80] 61 Fed. Reg. 32926, 32929 (June 26, 1996).
[81] See TD 9790
[82] Treas. Reg. § 1.1001-3(e)(5)(ii)(A).

rating), replacement of some or all units of the original collateral with other units of the same or similar type and aggregate value is not considered a change in the original collateral.[83]

(ii) Defeasance of Tax-Exempt Bonds. A defeasance of a tax-exempt bond is not a significant modification even if the issuer is released from any liability to make payments under the instrument if the defeasance occurs by operation of the terms of the original bond and the issuer places in trust government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond.[84]

(H) Accounting or Financial Covenants. A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.[85]

c. Rules of Application. Treas. Reg. § 1.1001-3(f) provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.[86]

(1) Testing for Significance.

(A) Contingent Modifications. If a modification is described in one of the specific categories above (other than changes to accounting or financial covenants) is effective only upon the occurrence of a substantial contingency, whether or not the change is a significant modification is determined under the General Significance Rule rather than under the specific rules.[87]

(B) Deferred Modifications. If a modification described in the changes in the obligor or security category or changes in the nature of a debt instrument category is effective on a substantially deferred basis, whether or not the change is a significant modification is determined under the General Significance Rule rather than under one of the specific rules.[88]

(2) Modifications That Are Not Significant. If a rule in the change in yield category, change in timing of payments category or change in obligor or security category prescribes a degree of change in a term of a debt instrument that is a significant modification, a change of the same type but of a lesser degree is not a significant modification under that rule. For example, a 20 basis point change in the yield of a fixed rate debt instrument is not a significant modification under the change in yield category. Likewise, if a rule in the change obligor or security category requires a change in payment expectations for a modification

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[83] Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2).
[84] Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(1).
[85] Treas. Reg. § 1.1001-3(e)(6).
[86] Treas. Reg. § 1.1001-3(e).
[87] Treas. Reg. § 1.1001-3(f)(1)(ii).
[88] Treas. Reg. § 1.1001-3(f)(1)(iii).

to be significant, a modification of the same type that does not result in a change in payment expectations is not a significant modification under that rule.[89]

(3) Cumulative Effect of Modifications. Two or more modifications of a debt instrument over any period of time constitute a significant modification if, had they been done as a single change, the change would have resulted in a significant modification. Thus, for example, a series of changes in the maturity of a debt instrument constitutes a significant modification if, combined as a single change, the change would have resulted in a significant modification. The significant modification occurs at the time that the cumulative modification would be significant. In testing for a change of yield under the change of yield category, however, any prior modification occurring more than 5 years before the date of the modification being tested is disregarded.[90]

(4) Modifications of Different Terms. Modifications of different terms of a debt instrument, none of which separately would be a significant modification under the specific rules described above, do not collectively constitute a significant modification. For example, a change in yield that is not a significant modification and a substitution of collateral that is not a significant modification do not together result in a significant modification. Although the significance of each modification is determined independently, in testing a particular modification it is assumed that all other simultaneous modifications have already occurred.[91]

(5) Certain Rules for Tax-Exempt Bonds.

(A) Conduit Loans. The obligor of a tax-exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. In determining whether there is a significant modification of a tax-exempt bond, however, transactions between holders of the tax-exempt bond and a borrower of a conduit loan may be an indirect modification. For example, a payment by the holder of a tax-exempt bond to a conduit borrower to waive a call right may result in an indirect modification of the tax-exempt bond by changing the yield on that bond.[92]

(A) Recourse Nature.

(i) General Rule. A tax-exempt bond that does not finance a conduit loan is a recourse debt instrument.[93]

(ii) Proceeds Used for Conduit Loans. A tax-exempt bond that finances a conduit loan is a recourse debt instrument unless both the bond and the conduit loan are nonrecourse instruments.[94]

(iii) Government Securities as Collateral. Notwithstanding the above rules, a tax-exempt bond that is secured only by a trust holding

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[89] Treas. Reg. § 1.1001-3(f)(2).
[90] Treas. Reg. § 1.1001-3(f)(3).
[91] Treas. Reg. § 1.1001-3(f)(4).
[92] Treas. Reg. § 1.1001-3(f)(6)(i).
[93] Treas. Reg. § 1.1001-3(f)(6)(ii)(A).
[94] Treas. Reg. § 1.1001-3(f)(6)(ii)(B).

government securities or tax-exempt government bonds that are reasonably expected to provide interest and principal payments sufficient to satisfy the payment obligations under the bond is a nonrecourse instrument.[95]

d. Examples. Treas. Reg. § 1.1001-3(g) contains examples illustrating the application of the foregoing rules.[96]

(1) ***Example (1):*** **Modification of Call Right.** Under the terms of a 30-year, fixed-rate bond, the issuer can call the bond for 102 percent of par at the end of ten years or for 101 percent of par at the end of 20 years. At the end of the eighth year, the holder of the bond pays the issuer to waive the issuer's right to call the bond at the end of the tenth year. On the date of the modification, the issuer's credit quality is approximately the same as when the bond was issued, but market rates of interest have declined from that date.[97]

The holder's payment to the issuer changes the yield on the bond. Whether the change in yield is a significant modification depends on whether the yield on the modified bond varies from the yield on the original bond by more than the greater of the greater of (a) 1/4 of one percent (25 basis points); or (b) 5 percent of the annual yield of the unmodified instrument (.05 × annual yield).[98] If the change in yield is not a significant modification, the elimination of the issuer's call right must also be tested for significance. Because the specific rules described above do not address this modification, the significance of the modification must be determined under the General Significance Rule.[99]

(2) ***Example (2):*** **Extension of Maturity and Change in Yield.** A zero-coupon bond has an original maturity of ten years. At the end of the fifth year, the parties agree to extend the maturity for a period of two years without increasing the stated redemption price at maturity (i.e., there are no additional payments due between the original and extended maturity dates, and the amount due at the extended maturity date is equal to the amount due at the original maturity date).[100]

The deferral of the scheduled payment at maturity is tested under the change in timing of payments category. The safe-harbor period under that category starts with the date the payment that is being deferred is due. For this modification, the safe-harbor period starts on the original maturity date, and ends five years from this date. All payments deferred within this period are unconditionally payable before the end of the safe-harbor period. Thus, the deferral of the payment at maturity for a period of two years is not a material deferral under the safe-harbor rule and thus is not a significant modification under the change in timing of payments category.[101]

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[95] Treas. Reg. § 1.1001-3(f)(6)(ii)(C).
[96] Treas. Reg. § 1.1001-3(g).
[97] Treas. Reg. § 1.1001-3(g), *Example (1)(i) (as amended by T.D. 9637).*
[98] Treas. Reg. § 1.1001-3(g), *Example (1).*
[99] Treas. Reg. § 1.1001-3(g), *Example (1)(iii)*.
[100] Treas. Reg. § 1.1001-3(g), *Example (2)(i)*.
[101] Treas. Reg. § 1.1001-3(g), *Example (2)(ii).*

Even though the extension of maturity is not a significant modification under the change in timing of payments category, the modification also decreases the yield of the bond.[102] The change in yield must be tested under the change in yield category.[103]

(3) ***Example (3):*** **Change in Yield Resulting from Reduction of Principal.** A debt instrument issued at par has an original maturity of ten years and provides for the payment of $100,000 at maturity with interest payments at the rate of 10 percent payable at the end of each year. At the end of the fifth year, and after the annual payment of interest, the issuer and holder agree to reduce the amount payable at maturity to $80,000. The annual interest rate remains at 10 percent but is payable on the reduced principal.[104] In applying the change in yield rule, the yield of the instrument after the modification (measured from the date that the parties agree to the modification to its final maturity date) is computed using the adjusted issue price of $100,000. With four annual payments of $8,000, and a payment of $88,000 at maturity, the yield on the instrument after the modification for purposes of determining if there has been a significant modification under the change in yield category is 4.332 percent. Thus, the reduction in principal is a significant modification.[105]

(4) ***Example (4):*** **Deferral of Scheduled Interest Payments.** A 20-year debt instrument issued at par provides for the payment of $100,000 at maturity with annual interest payments at the rate of 10 percent. At the beginning of the eleventh year, the issuer and holder agree to defer all remaining interest payments until maturity with compounding. The yield of the modified instrument remains at 10 percent.[106]

The safe-harbor period under the change in timing of payments category begins at the end of the eleventh year, when the interest payment for that year is deferred, and ends at the end of the sixteenth year. However, the payments deferred during this period are not unconditionally payable by the end of that 5-year period. Thus, the deferral of the interest payments is not within the safe-harbor period.[107]

This modification materially defers the payments due under the instrument and is a significant modification under the change in timing of payments category.[108]

(5) ***Example (5):*** **Assumption of Mortgage with Increase in Interest Rate. A recourse debt instrument with a 9 percent annual yield is secured by an office building.** Under the terms of the instrument, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser is equally or more creditworthy than the original obligor and if the interest rate on the instrument is increased by one-half percent (50 basis points). The building is sold, the purchaser assumes the debt, and the interest rate increases by 50 basis points.[109]

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[102] Treas. Reg. § 1.1001-3(g), *Example 2(iii)*.
[103] Treas. Reg. § 1.1001-3(g), *Example (2)(iii)*.
[104] Treas. Reg. § 1.1001-3(g), *Example (3)(i)*.
[105] Treas. Reg. § 1.1001-3(g), *Example (3)(ii)*.
[106] Treas. Reg. § 1.1001-3(g), *Example (4)(i)*.
[107] Treas. Reg. § 1.1001-3(g), *Example (4)(ii)*.
[108] Treas. Reg. § 1.1001-3(g), *Example 4(iii)*.
[109] Treas. Reg. § 1.1001-3(g), *Example (5)(i)* (as amended by T.D. 9637).

If the purchaser's acquisition of the building does not satisfy the requirements of the exceptions for Section 381 transactions or certain asset acquisitions, the substitution of the purchaser as the obligor is a significant modification under the general rule for substitution of new obligor on a recourse debt instrument category.[110] If the purchaser acquires substantially all of the assets of the original obligor, the assumption of the debt instrument will not result in a significant modification if there is not a change in payment expectations and the assumption does not result in a significant alteration.[111]

The change in the interest rate, if tested under the change in yield rules would result in a significant modification. The change in interest rate that results from the transaction is a significant alteration. Thus, the transaction is a significant modification under the change in obligor or security category.[112]

(6) ***Example (6):*** **Assumption of Mortgage.** A recourse debt instrument is secured by a building. In connection with the sale of the building, the purchaser of the building assumes the debt and is substituted as the new obligor on the debt instrument. The purchaser does not acquire substantially all of the assets of the original obligor.[113]

The transaction does not satisfy the exceptions for certain Section 381(a) transactions or certain asset acquisitions.[114] Thus, the substitution of the purchaser as the obligor is a significant modification.[115]

Section 1274(c)(4), however, provides that if a debt instrument is assumed in connection with the sale or exchange of property, the assumption is not taken into account in determining if section 1274 applies to the debt instrument unless the terms and conditions of the debt instrument are modified in connection with the sale or exchange. Because the purchaser assumed the debt instrument in connection with the sale of property and the debt instrument was not otherwise modified, the debt instrument is not retested to determine whether it provides for adequate stated interest.[116]

(7) ***Example (7):*** **Substitution of a New Obligor in Section 381(a) Transaction.** The interest rate on a 30-year debt instrument issued by a corporation provides for a variable rate of interest that is reset annually on June 1st based on an objective index.[117]

In the tenth year, the issuer merges (in a transaction to which section 381(a) applies) into another corporation that becomes the new obligor on the debt instrument. The merger occurs on June 1st, at which time the interest rate is also reset by operation of the terms of the instrument. The new interest rate varies from the previous interest rate by more than the greater of 25 basis

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[110] Treas. Reg. § 1.1001-3(g), *Example (5)(ii)* (as amended by T.D. 9637).
[111] Treas. Reg. § 1.1001-3(g), *Example (5)(iii)* (as amended by T.D. 9637).
[112] Treas. Reg. § 1.1001-3(g), *Example (5)(iv)* (as amended by T.D. 9637).
[113] Treas. Reg. § 1.1001-3(g), *Example (6)(i)*.
[114] *See* discussion above regarding Treas. Reg. §§ 1.1001-3(e)(4)(i)(B) and (C).
[115] Treas. Reg. § 1.1001-3(g), *Example (6)(ii)*.
[116] Treas. Reg. § 1.1001-3(g), *Example (6)(iii)*.
[117] Treas. Reg. § 1.1001-3(g), *Example (7)(i)*.

points and 5 percent of the annual yield of the unmodified instrument. The substitution of a new obligor does not result in a change in payment expectations.[118]

The substitution of the new obligor occurs in a section 381(a) transaction and does not result in a change in payment expectations. Although the interest rate changed by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument, this alteration did not occur as a result of the transaction and is not a significant alteration. Thus, the substitution meets the requirements of the exception for certain Section 381(a) transactions and is not a significant modification.[119]

(8) ***Example (8):*** **Substitution of Credit Enhancement Contract.** Under the terms of a recourse debt instrument, the issuer's obligations are secured by a letter of credit from a specified bank. The debt instrument does not contain any provision allowing a substitution of a letter of credit from a different bank. The specified bank, however, encounters financial difficulty. The issuer and holder agree that the issuer will substitute a letter of credit from another bank.[120]

The substitution of a different credit enhancement contract is not a significant modification of a recourse debt instrument unless the substitution results in a change in payment expectations. While the substitution of a new letter of credit by a different bank does not itself result in a change in payment expectations, such a substitution may result in a change in payment expectations under certain circumstances (for example, if the obligor's capacity to meet payment obligations is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate).[121]

(9) ***Example (9):*** **Improvement to Collateral Securing Nonrecourse Debt.** A parcel of land and its improvements, a shopping center, secure a nonrecourse debt instrument. The obligor expands the shopping center with the construction of an additional building on the same parcel of land. After the construction, the improvements that secure the nonrecourse debt include the new building. The building is an improvement to the property securing the nonrecourse debt instrument and its inclusion in the collateral securing the debt is not a significant modification under the rule that provides that property improvements securing a nonrecourse debt do not result in a significant modification.[122]

4. Analysis of Step Three: If a Modification of a Debt Instrument is Significant, Determine the Federal Income Tax Consequences of the Deemed Exchange to the Issuer and the Holder of the Debt Instrument. A significant modification that results in an exchange of the unmodified note for the modified note, may result in tax consequences for both the issuer and holder of the note. However, even if a modification results in a deemed exchange under the regulations, the holder and issuer may not realize gain or loss. For example, the refinancing of a residential mortgage with the same lender or the modification of a small business

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[118] Treas. Reg. § 1.1001-3(g), *Example (7)(ii)*.
[119] Treas. Reg. § 1.1001-3(g), *Example (7)(iii)*.
[120] Treas. Reg. § 1.1001-3(g), *Example (8)(i)* (as amended by T.D. 9637).
[121] Treas. Reg. § 1.1001-3(g), Example (8)(ii) (as amended by T.D. 9637).
[122] Treas. Reg. § 1.1001-3(g), *Example (9); see* Treas. Reg. § 1.1001-3(e)(4)(iv)(B).

loan typically will not have tax consequences for either the issuers or the holders. The federal income tax consequences to the holder and issuer are further discussed below.

a. Consequences to Holder of Modified Debt Instrument. Under section 1001 of the Code, the gain or loss from an exchange of property is determined by reference to the amount realized by the taxpayer from the exchange and the taxpayer's adjusted basis in the property as determined under section 1011.

(1) Amount Realized. Treas. Reg. § 1.1001-1(g)(1) provides that if a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under §1.1273-2 or §1.1274-2, whichever is applicable.[123] In a deemed exchange of debt instruments, the modified debt instrument should be treated as issued in exchange for the unmodified debt instrument.[124] Certain exceptions apply for instruments that provide for contingent payments.[125]

(2) Basis. If a debt instrument is issued in exchange for property, the cost of the property that is attributable to the debt instrument is the issue price of the debt instrument.[126]

Thus, when a debt is significantly modified, a taxpayer (holder) is generally required to recognize gain or loss based on the difference between the issue price of the significantly modified debt and the taxpayer's adjusted issue price in the original instrument.[127]

(3) Determination of Issue Price. The issue price is primarily determined under Treas. Reg. § 1.1273-2 or §1.1274-2, whichever is applicable.[128] The determination of the issue price of debt instruments can be tedious and complex, and a complete discussion of such determination is beyond the scope of this outline. Below is a brief summary of how analysis could be approached.

(A) Debt Instruments Issued for Money. Generally, if a substantial amount of the debt instruments in an issue is issued for money, the issue price of each debt instrument in the issue is the first price at which a substantial amount of the debt instruments is sold for money. Thus, if an issue consists of a single debt instrument that is issued for money,

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123 *Cf.* F.S.A. 1998-27 (Oct. 13, 1993) ("Proposed regulation section 1.1001-1(g) states that in the case of a debt instrument issued in exchange for property, the amount realized attributable to a debt instrument is the issue price as determined under proposed regulation section 1.1273-2 or proposed regulation section 1.1274-2(b). In cases involving a deemed exchange of publicly traded debt instruments, the issue price of the new debt will be the fair market value of the traded debt. In other cases, if the debt instrument has adequate stated interest and is issued at par, the issue price will be its face amount.").

124 *See* Rev. Rul. 89-122, 1989-2 C.B. 200 ("In Situations 1 and 2, the modification of the Obligation results in a deemed exchange under section 1001 of the Code, and, therefore, the modified Obligation is treated as a newly issued debt instrument for federal income tax purposes. Because the modified Obligation in each situation is issued for nonpublicly traded property (the original Obligation), section 1274 generally determines the issue price of the modified Obligation."); F.S.A. 2317 (Mar. 31, 1998) (citing Rev. Rul. 89-122 for the proposition that the reduction in the principal *amount of "old" debt resulted in a deemed exchange for purposes of sections 1001 and 1274.*

125 *See* Treas. Reg. § 1.1001-1(g)(2).

126 *See* Treas. Reg. § 1.1012-1(g)(1).

127 T.D. 8676, 1996-2 C.B. 9, 10.

128 *See* Treas. Reg. § 1.1012-1(g)(1).

the issue price of the debt instrument is the amount paid for the instrument. For example, in the case of a debt instrument evidencing a loan to a natural person, the issue price of the instrument is the amount loaned.[129]

(B) Publicly Traded Debt Instruments Issued for Property. If a substantial amount of the debt instruments in an issue is traded on an established market[130] and a substantial amount of the debt instrument is not described in subparagraph (A) above, the issue price of each debt instrument in the issue is the fair market value of the debt instrument, determined as of the first date on which a substantial amount of the traded debt instruments in the issue is issued.[131] See Treas. Reg. § 1273-2(f) for rules to determine the fair market value of a debt instrument.

(C) Debt Instruments Issued for Publicly Traded Property. If a substantial amount of the debt instruments in an issue is issued for property[132] that is traded on an established market[133] and the issue is not described in subparagraphs (A) or (B) above, the issue price of each debt instrument in the issue is the fair market value of the property, determined as of the first date on which a substantial amount of the debt instruments in the issue is issued for traded property.[134] See Treas. Reg. § 1273-2(f) for rules to determine the fair market value of property for purposes of these rules.

(D) Other Debt Instruments. If an issue of debt instruments is not described in subparagraphs (A), (B), or (C) above,[135] then the determination of issue price depends on whether Section 1274 applies.

(i) Debt Instruments to which Section 1274 Applies. Among other exceptions, Section 1274 does not apply to debt instruments that have adequate stated interest and no original issue discount.[136] A detailed discussion of this determination is beyond the scope of this outline.

(ii) Debt Instruments to which Section 1274 Does Not Apply. If an issue of debt instruments is not described in subparagraphs (A), (B), or (C) above and Section 1274 does not apply, the issue price of the debt instrument is its stated redemption price at maturity under section 1273(b)(4).[137] The term "stated redemption price at maturity" means the amount fixed by the last modification of the purchase agreement and includes interest and other amounts payable at that time (other than any interest based on a fixed rate, and

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[129] Treas. Reg. § 1273-2(a)(1).
[130] See Treas. Reg. § 1273-2(f) (defining when property is traded on an established market).
[131] See Treas. Reg. § 1273-2(b).
[132] For purposes of the preceding sentence, property means a debt instrument, stock, security, contract, commodity, or nonfunctional currency. But see §1.988-2(b)(2) for circumstances when nonfunctional currency is treated as money rather than as property.
[133] See Treas. Reg. § 1273-2(f) (defining when property is traded on an established market).
[134] Treas. Reg. § 1.1273-2(c).
[135] Treas. Reg. § 1.1273-2(d) provides rules requiring that if an issue doesn't meet the descriptions in subpagaraph (A), (B) or (C), then the analysis is performed again as if "each debt instrument in the issue debt . . . were a separate issue."
[136] *See* Treas. Reg. § 1.1274-1(b)(1).
[137] *See* Treas. Reg. § 1.1273-2(d)(1).

payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).[138]

b. Consequences to Debtor. Treas. Reg. § 1.61-12(c)(2)(i) provides that generally an issuer does not realize gain or loss upon the repurchase of a debt instrument.[139] The regulations provide that the term *repurchase* includes the retirement of a debt instrument, the conversion of a debt instrument into stock of the issuer, and the exchange (including an exchange under section 1001) of a newly issued debt instrument for an existing debt instrument.[140] However, a repurchase at a discount or premium may result in consequences that need to be analyzed.

(1) Repurchase at a Discount.

(A) Issuer Realizes Discharge of Indebtedness Income Upon Repurchase. An issuer realizes income from the discharge of indebtedness upon the repurchase of a debt instrument for an amount less than its "adjusted issue price" (within the meaning of §1.1275-1(b)).[141] The amount of discharge of indebtedness income is equal to the excess of the adjusted issue price over the repurchase price.[142] Treasury Regulation Section 1.61-12(c)(2)(i) provides further guidance by directing the reader to "[s]ee section 108 and the regulations thereunder for additional rules relating to income from discharge of indebtedness. For example, to determine the repurchase price of a debt instrument that is repurchased through the issuance of a new debt instrument, see section 108(e)(10)."[143]

(i) Adjusted Issue Price of Repurchased Debt Instrument. Generally, the adjusted issue price of a debt instrument at the beginning of the first accrual period is the issue price.[144] Thereafter, the adjusted issue price of the debt instrument is the issue price of the debt instrument (i) increased by the amount of OID previously includible in the gross income of any holder; and (ii) decreased by the amount of any payment previously made on the debt instrument other than a payment of qualified stated interest.[145]

(ii) Repurchase Price Under Section 108(e)(10(A). Section 108(e)(10)(A) provides that, for purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of

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[138] *See* I.R.C. § 1273(a)(2).
[139] The regulations provide, however, that if a debt instrument provides for payments denominated in, or determined by reference to, a nonfunctional currency, an issuer may realize a currency gain or loss upon the repurchase of the instrument. Treas. Reg. § 1.61-12(c)(2)(i).
[140] Treas. Reg. § 1.61-12(c)(2)(i).
[141] Treas. Reg. § 1.61-12(c)(2)(ii).
[142] Treas. Reg. § 1.61-12(c)(2)(i).
[143] Treas. Reg. § 1.61-12(c)(2)(ii). H.R. Rep. No. 111-16, at 562 (2009) (Conf. Rep.) stating as follows: If a debtor issues a debt instrument in satisfaction of its indebtedness, the debtor is treated as having satisfied the indebtedness with an amount of money equal to the issue price of the newly issued debt instrument. The issue price of such newly issued debt instrument generally is determined under sections 1273 and 1274 . Similarly, a "significant modification" of a debt instrument, within the meaning of Treas. Reg. sec. 1.1001-3, results in an exchange of the original debt instrument for a modified instrument. In such cases, where the issue price of the modified debt instrument is less than the adjusted issue price of the original debt instrument, the debtor will have income from the cancellation of indebtedness.
[144] Treas. Reg. § 1.1275-1(b)(1).
[145] Treas. Reg. § 1.1275-1(b)(1).

indebtedness, such debtor is treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument. For purposes of Section 108(e)(10)(A), the issue price of any debt instrument is determined under sections 1273 and 1274.[146] For purposes of this rule, Section 1273(b)(4) is applied by reducing the stated redemption price of any instrument by the portion of such stated redemption price which is treated as interest.[147]

(B) Original Issue Discount. If a new debt instrument is issued as a result of a significant modification to a debt instrument, such debt instrument will have original issue discount if the new debt instrument's stated redemption price at maturity exceeds its issue price.[148] In general, an issuer of a debt instrument with original issue discount may deduct for any taxable year, with respect to such debt instrument, an amount of original issue discount equal to the aggregate daily portions of the original issue discount for days during such taxable year.[149]

(2) Repurchase at a Premium. An issuer may be entitled to a repurchase premium deduction upon the repurchase of a debt instrument for an amount greater than its adjusted issue price.[150] Treas. Reg. §1.163-7(c) provides rules for the treatment of repurchase premium.[151]

c. Special Considerations

(1) Original Issue Discount. A deemed exchange of the unmodified debt instrument for the modified debt instrument raises concerns regarding the potential presence of "original issue discount" in the new debt. If the modified debt's stated redemption price at maturity exceeds its issue price, it may carry OID, which can carry adverse tax consequences for the holder and issuer of the debt instrument.

(2) Partial Bad Debt Deductions. The final regulations provide limited circumstances under which a taxpayer will be permitted to deduct an amount on account of a partially worthless debt even though no amount has been charged off within the taxable year. The purpose of the regulations is to preserve the portion of a taxpayer's bad debt deduction with respect to a partially worthless debt that corresponds to the amount the taxpayer would have been entitled to deduct for partial worthlessness with respect to the modified debt if the book basis of the modified debt were increased to the same extent as the tax basis of that debt. Thus, these

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[146] I.R.C. 108(e)(10)(B).

[147] I.R.C. § 108(e)(10)(B).

[148] *See* I.R.C. § 1273.

[149] I.R.C. § 163(e). H.R. Rep. No. 111-16, at 562 (2009) (Conf. Rep.) stating as follows: If any new debt instrument is issued (including as a result of a significant modification to a debt instrument), such debt instrument will have original issue discount equal to the excess (if any) of such debt instrument's stated redemption price at maturity over its issue price. In general, an issuer of a debt instrument with original issue discount may deduct for any taxable year, with respect to such debt instrument, an amount of original issue discount equal to the aggregate daily portions of the original issue discount for days during such taxable year.

[150] Treas. Reg. § 1.61-12(c)(2)(i). Treas. Reg. § 1.1275-1(b) defines repurchase premium.

[151] Treas. Reg. § 1.61-12(c)(2)(i); *cf.* Priv. Ltr. Rul. 200742016 (Oct. 19, 2007) (("1. The exchange of tendered Debt 3 for New Debt will result in a significant modification of Debt 3 under section 1.1001-3(e)(4)(i). * * * 2. To the extent the issue price of New Debt exceeds the adjusted issue price of Debt 3, the difference will be treated as a repurchase premium. Any resulting repurchase premium is deductible by Sub 1 as interest under section 1.163-7(c) in the year that the Exchange occurs.").

regulations apply only if all of the following conditions are satisfied. First, a significant modification of a debt instrument (within the meaning of §1.1001-3) must result in a taxpayer's recognition of gain under § 1.1001-1(a).[152] In addition, the debt must have claimed a deduction for partial worthlessness of the debt in a prior tax year and the prior charge-off and deduction must have satisfied the requirements of §1.166-3(a)(1) and (2).[153] If these conditions are satisfied, then a modified debt is deemed to have been charged off in the year in which gain is recognized.[154] The amount of the deemed charge- off, if any, is the amount by which the tax basis of the debt exceeds the greater of the fair market value of the debt or the amount of the debt recorded on the taxpayer's books and records reduced as appropriate for a specific allowance for loan losses.[155] The amount of the deemed charge-off, however, may not exceed the amount of recognized gain.[156]

(3) Nonrecognition Provisions. An exception to the recognition requirement may apply in the case of corporate debt that constitutes a security.[157]

(4) 453B dispositions. A holder of an installment note may be deemed to have made a "disposition" of such note for purposes of Section 453B, thereby triggering a current recognition of all or part of the deferred gain. But it generally takes more to trigger a Section 453B "disposition" than a Section 1001 exchange To that end, the IRS has been liberal, given the policy considerations, in ruling that a disposition by a holder does not occur under this provision when: the interest rate is increased and the maturity date deferred; the principal amount is reduced; a single note is split in two; a new obligor is added or substituted; or the security of the note is changed.

(5) Compensation Income. An exchange of an obligation issued by an employee or other service provider for the purchase of property (e.g., employer stock) in connection with the performance of services can result in compensation income to the service

[152] Treas. Reg. § 1.166-3(a)(3)(i).
[153] Treas. Reg. § 1.166-3(a)(3)(ii).
[154] Treas. Reg. § 1.166-3(a)(3)(i).
[155] Treas. Reg. § 1.166-3(a)(3)(iii).
[156] Treas. Reg. § 1.166-3(a)(3)(iii); *see* Temp. Reg. Preamble, T.D. 8676, 1996-2 C.B. 9, 11; *see also* T.D. 8763, 1998-15 C.B. 840, 841 ("Three comments were received on the §1.166-3T regulations. The first comment requests a deemed charge-off for a taxpayer that purchased at a discount debt for which a previous deduction for partial worthlessness was claimed, and then significantly modified the debt under §1.1001-3 and recognized gain on the modification. Whenever debt is purchased for less than the stated redemption price, recognized gain from a significant modification is attributable to market discount as defined in section 1278(a)(2)(A) and not to a previously claimed deduction for partial worthlessness. In addition, the temporary regulations refer to §1.166-3(a) (1) and (2) for guidance relating to prior charge-offs and deductions for partial worthlessness. Extending the temporary regulations to cover a discount purchase would significantly expand the regulations beyond their intended scope and create a situation that would be extremely difficult to administer. The regulations do not adopt the request to extend the regulations to cover such a purchase.").
[157] Notice of Proposed Rulemaking FI-31-92, 57 Fed. Reg. 57034, 57035 ("The realization of gain or loss by the holder generally will depend on whether the issue price of the new instrument is less than or greater than the holder's basis in the original instrument. In addition, even if a gain or loss is realized, certain nonrecognition provisions of the Code may apply."). For an insightful analysis of the rules cited in the text, *see* Ridgway and Purnell, *When Good Loans Go Bad, Selected Tax Issues for Corporations Holding or Owing Troubled Debt*, 49 T.M. Memorandum 9 (Apr. 28, 2008) and Exchanges of Debt for Debt, Portfolio 774-3rd: Single Entity Reorganizations: Recapitalizations and F Reorganizations 2009.

provider. The IRS has concluded generally that the reduction in a stated principal amount results in compensation income.

(6) Contingent Debt Instruments. Frequent in real estate restructurings is the addition of a contingent interest feature, either in addition to or in lieu of the preexisting interest on the debt. Such interest may be contingent on operational cash flow or the appreciation in or sale of the underlying property.