

DATES: These regulations are effective September 24, 1996.

For dates of applicability of these regulations, see § 1.1001-3(h).

FOR FURTHER INFORMATION CONTACT: Thomas J. Kelly, (202) 622-3930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

*Background*

On December 2, 1992, proposed amendments to 26 CFR part 1 were published in the **Federal Register** (57 FR 57034 [FI-31-92, 1992-2 C.B. 683]) to provide guidance under § 1.1001-3. The proposed regulations relate to the modification of debt instruments. On February 17, 1993, the IRS held a public hearing on the proposed regulations. In addition, the IRS received numerous written comments on the proposed regulations. The proposed regulations, with certain changes made in response to comments, are adopted in this Treasury decision as final regulations. The principal changes to the regulations, as well as the major comments and suggestions, are discussed below.

*Explanation of Provisions*

A. General

The preamble to the proposed regulations states that the proposed regulations are intended to address the uncertainty concerning when the modification of a debt instrument results in a deemed exchange of the old debt instrument for a new instrument. Some of this uncertainty resulted from the possible impact of the decision of the Supreme Court in *Cottage Savings Ass'n v. Commissioner*, 499 U.S. 554 (1991). The preamble invites comments with respect to whether it is desirable to provide rules for the modification of debt instruments as well as comments with respect to what those rules should be.

Although the IRS received many comments on the proposed regulations, relatively few commentators addressed the question of whether regulations on the modification of debt instruments are desirable. A few commentators argued against the promulgation of regulations on this subject. A number of other commentators were supportive of the attempt to provide certainty through a series of specific rules. Some commentators suggested that the regulations

adopt a facts and circumstances approach with safe harbors under which certain modifications would not be treated as exchanges. In contrast, other commentators suggested using additional bright-line rules to provide more certainty with respect to when a modification is, and is not, treated as an exchange of the old debt instrument for a new instrument. Most commentators, however, limited their comments to the specific rules of the proposed regulations.

The IRS and Treasury considered adopting a single, general rule instead of several detailed rules. That approach, while providing less guidance, would have the advantage of reducing complexity and avoiding anomalies that can result from bright-line rules (for example, different results for economically similar transactions). Nevertheless, after considering that approach the IRS and Treasury concluded that both taxpayers and the IRS would benefit from regulations specifically addressing the treatment of certain modifications. A debt modification that results in an exchange may have a variety of consequences, and parties contemplating a change to a debt instrument should be able to determine whether that change will result in an exchange.

Accordingly, the final regulations retain the basic structure of the proposed regulations. Thus, an alteration of the terms of a debt instrument is first tested to determine whether the alteration is a "modification." If there is a modification, the modification is then tested to determine whether it is a "significant modification." A significant modification results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent within the meaning of § 1.1001-1(a).

Although the final regulations generally follow the approach of the proposed regulations, certain rules have been added or modified to address a number of issues noted by commentators. For example, in one instance the final regulations provide a general rule with respect to a particular type of modification together with a safe harbor for certain changes that will not result in exchanges. In other instances, the final regulations retain the bright-line approach of the proposed regulations. The IRS and Treasury invite comments on

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**Section 1001.—Determination of Amount of and Recognition of Gain or Loss**

*26 CFR 1.1001-3: Modifications of debt instruments.*

**T.D. 8675**

**DEPARTMENT OF THE TREASURY  
Internal Revenue Service  
26 CFR Part 1**

**RIN 1545-AR04  
Modifications of Debt Instruments**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the modification of debt instruments. The regulations govern when a modification is treated as an exchange of the original debt instrument for a modified instrument. The regulations provide needed guidance to issuers and holders of debt instruments.

the operation of the final regulations and will consider providing additional guidance as appropriate.

## B. Other instruments

In the preamble to the proposed regulations, the IRS invites comments with respect to whether the regulations should be expanded to address modifications of financial instruments other than debt instruments. In response, several commentators argued that a dealer's assignment of its position in an interest rate swap contract or other notional principal contract should not result in an exchange under section 1001 for the nonassigning counterparty. In response to these comments, the IRS and Treasury are issuing proposed and temporary regulations that provide a special rule for dealer assignments of notional principal contracts. However, those temporary and proposed regulations and these final regulations do not address whether particular instruments are debt instruments for Federal income tax purposes.

With the exception of those temporary and proposed regulations, the final regulations have not been expanded to cover the modification of financial instruments other than debt instruments. The modification of other instruments is less common than the modification of debt instruments, and the rules for modifications of debt instruments would not necessarily work well or be appropriate in determining whether modifications of other instruments result in exchanges under section 1001. For equity instruments in particular, the IRS and Treasury believe that the application of certain rules in these regulations would be inappropriate. Similarly, for contracts that are not debt instruments, the final regulations do not limit or otherwise affect the application of the "fundamental change" concept articulated in Rev. Rul. 90-109 (1990-2 C.B. 191), in which the IRS concluded that the exercise by a life insurance policyholder of an option to change the insured under the policy changed "the fundamental substance" of the contract, and thus was a disposition under section 1001.

## C. Modifications

The final regulations retain the general rule of the proposed regulations that a modification includes any alteration of a legal right or obligation of the issuer or holder. The final regulations, however, do not adopt the rule of the proposed regulations that a unilateral waiver of a right that does not rise to

the level of a settlement of terms between the parties is not a modification of the original instrument. Commentators noted that it often is impossible to distinguish between a unilateral waiver of a right and a workout agreed to by the parties in which only the holder of the instrument makes meaningful concessions. Moreover, in the case of a prepayable debt instrument, the holder's waiver of rights may be an inducement to the obligor not to terminate the debt instrument.

In defining when an alteration is a modification, the final regulations also generally retain the rule that a change in a term of a debt instrument that occurs by operation of the terms of a debt instrument is not a modification. A change may occur by operation of the terms of an instrument at a specified time, as a result of a contingency specified in the instrument, or upon the exercise of an option provided for in the instrument to change a term.

The final regulations limit the application of the rule for changes that occur by operation of the terms of a debt instrument in three respects. First, the final regulations retain the rule of the proposed regulations that any alteration that results in an instrument or property right that is not debt for federal income tax purposes is a modification, even if the alteration occurs by operation of the terms of the instrument (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). Second, the final regulations also provide that any alteration that results in a substitution of a new obligor, the addition or deletion of a co-obligor, or a change in the recourse nature of an instrument is a modification. The IRS and Treasury believe that these changes may be so fundamental that they should be considered modifications even if they occur by operation of the terms of an instrument. Thus, these modifications always must be tested for significance to determine whether they result in exchanges.

Third, the final regulations provide that 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 (defined essentially in the same manner as in the proposed regulations) and (ii) holder options the exercise of which results in a deferral or a reduction in any scheduled payment of interest or principal. 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. In this regard, the rule for holder options resulting in deferrals or reductions of payments addresses more specifically the concerns underlying the proposed regulations' rule discussed above regarding unilateral waivers that rise to the level of a settlement of the terms.

Many commentators argued that the proposed regulations are overly restrictive in recognizing only temporary nonperformance by the issuer and temporary waivers of default rights by holders as not being modifications. In particular, commentators expressed concern about an example in the proposed regulations that illustrates the temporary waiver rule with a situation in which the waiver is only for a 3-month period. The IRS and Treasury recognize that parties may need a period of time to modify the terms of a debt instrument following an issuer's default and that a holder's waiver or nonenforcement of default rights may not itself evidence an agreement with respect to new terms.

The final regulations respond to these comments in two respects. First, the regulations provide that nonperformance by the issuer is not, in and of itself, a modification. Second, the regulations provide a limited exception to the rule that a waiver of rights is a modification. Under this exception, absent an actual written or oral agreement by the issuer and the holder to alter other terms of the instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right is not a modification for a period of two years following the issuer's nonperformance, or for a longer period (after the initial two-year period) during which the parties conduct good faith negotiations or during the pendency of bankruptcy proceedings. Once the parties agree to new terms, however, there is a modification of the instrument.

As under the proposed regulations, a modification is tested when the parties agree to a change even if the change is not immediately effective, but the final regulations add exceptions for a change in a term that is agreed to by the parties but is subject to reasonable closing conditions or that occurs as a result of bankruptcy proceedings. In these cases, a modification occurs on the date the change in the term becomes effective.

Thus, if the conditions do not occur (and the change in the term does not become effective), a modification does not occur.

#### D. Significant modifications

The final regulations retain the structure of the proposed regulations for determining whether a modification is significant, but change a number of the specific rules for particular types of modifications. The final regulations also add a new general rule for types of modifications for which specific rules are not provided. Under this general rule (the general significance rule), a modification is significant if, based on all the facts and circumstances, the legal rights or obligations being changed and the degree to which they are being changed are economically significant. The general significance rule also applies to a type of modification for which specific rules are provided if the modification is effective upon the occurrence of a substantial contingency. Moreover, the general significance rule will apply for certain types of modifications that are effective on a substantially deferred basis. When testing a modification under the general significance rule, all modifications made to the instrument (other than those for which specific bright-line rules are provided) are considered collectively. Thus, a series of related modifications, each of which independently is not significant under the general significance rule, may together constitute a significant modification.

With the addition of the general significance rule, certain specific rules of the proposed regulations have not been included in the final regulations. For example, under the proposed regulations, whether the addition or deletion of a put or call right is a significant modification depends on the value of the put or call. The significance of an alteration of a put or call right depends on whether the alteration significantly affects the value of the right. The proposed regulations provide similar rules for the addition, deletion, or alteration of a conversion or exchange right. Under the proposed regulations, certain changes in the types of payments under a debt instrument (for example, a change from a fixed rate debt instrument to a variable rate or contingent payment debt instrument) are significant modifications. These rules have not been included in the final regulations because the general significance rule provides adequate guidance.

For changes in the yield of a debt instrument, the final regulations provide that a change in yield is significant if the change exceeds the greater of 25 basis points or five percent of the original yield on the instrument. This rule was modified in response to comments that a change of more than 25 basis points should be permitted in the case of debt instruments issued with high interest rates. The final regulations also limit this change-of-yield bright-line rule to fixed rate and variable rate debt instruments. Because of the difficulties in developing appropriate mechanisms for measuring changes in the yield of other debt instruments (for example, contingent payment debt instruments), the final regulations provide that the significance of changes in the yield of those other instruments is determined under the general significance rule. The final regulations also incorporate other technical changes to clarify the application of the change-in-yield rules.

The final regulations do not adopt the suggestion of some commentators that a reduction in the principal amount of a debt instrument should not be considered a modification. As under the proposed regulations, for purposes of determining if there is a significant modification, the yield on the modified instrument is computed by reference to the adjusted issue price immediately before the modification. 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.

For changes in the timing of payments (including any resulting change in the amount of payments), the proposed regulations contain a rule that an extension of the final maturity of an instrument for the lesser of five years or 50 percent of the original term of the instrument is not a significant modification. Any other change in the timing of payments is subject to two rules. Under the first rule, any material deferral of payments is a significant modification. Under the second rule, any change in terms designed to avoid the application

of the rules for original issue discount is a significant modification. Commentators objected to both of these rules because they do not provide bright-line rules for determining whether a modification is significant. In addition, the commentators argued that an example in the proposed regulations that concerns the deferral of interim payments is inconsistent with the rule for an extension of final maturity.

The final regulations combine the rules for extensions of final maturity and other changes in the timing and/or amounts of payments. While adopting the material deferral rule generally, the final regulations also allow the deferral of payments within a safe-harbor period (the lesser of five years or 50 percent of the original term of the instrument) if the deferred amounts are unconditionally payable at the end of that period. The final regulations do not contain the rule that the Commissioner may treat any deferral of payments made with a principal purpose of avoiding the time value of money rules, including the rules for original issue discount, as a significant modification. The concerns addressed by this rule in the proposed regulations have been resolved in final regulations recently issued under section 1275. See § 1.1275-2(j).

For a change in the obligor on an instrument, the final regulations retain the general rule in the proposed regulations that changing the obligor on a recourse debt instrument is significant. In addition to the exception for section 381(a) transactions in the proposed regulations, the final regulations include an exception for transactions in which the new obligor acquires substantially all of the assets of the original obligor. Each exception must meet two requirements. First, other than the substitution of a new obligor, the transaction must not result in any alteration that would be a significant modification but for the fact that it occurs by operation of the terms of the instrument. Second, the transaction must not result in a change in payment expectations. The final regulations also provide that 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 and the collateral securing the instrument continues to include the original collateral.

A change in payment expectations occurs if there is a substantial enhancement or impairment of the obligor's capacity to meet its payment obligations

under the instrument and the enhancement or impairment results in a change to an adequate capacity from a speculative capacity or vice versa. There is no change in payment expectations, however, if the obligor has at least an adequate capacity to meet its payment obligations both before and after the modification.

The final regulations also apply the payment expectations test to determine whether the addition or deletion of a co-obligor is a significant modification. Similarly, the final regulations provide that whether certain other modifications are significant is determined by reference to whether the modifications result in a change in payment expectations. Those modifications include (i) the release, substitution, or addition of collateral as security for a recourse debt, (ii) the addition, deletion, or alteration of a guarantee or other credit enhancement, and (iii) a change in the priority of a debt instrument. As under the proposed regulations, a modification that releases, substitutes, or adds a substantial amount of collateral as security for a nonrecourse debt instrument is a significant modification.

A number of commentators raised questions regarding the circumstances under which the modification of a debt instrument will require a determination of whether the modified instrument is debt or equity. Many expressed concern that a deterioration in the financial condition of the issuer between the date of original issuance and the date of the modification could lead to a determination that the modified instrument is not debt for tax purposes. The final regulations address this concern by providing a rule that for purposes of this regulation, unless there is a substitution of a new obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt.

The final regulations also modify the rules pertaining to the significance of changes in the method under which payments are calculated. The proposed regulations provide that a modification is significant if it results in a change between the categories of fixed rate, variable rate, and contingent payment instruments or if it changes the currency in which payment under the debt instrument is made. The Treasury and the IRS determined that such an approach was both too broad and too narrow (i.e., certain changes involving economically

insignificant adjustments would be characterized as significant, while other more economically dramatic changes would not be characterized as significant). Accordingly, the final regulations do not provide any bright-line rules so that the significance of any change in the method under which payments are calculated is determined under the general significance rule.

The final regulations adopt the rule of the proposed regulations that a change in the recourse nature of an instrument is a significant modification, but limit this specific rule to changes from substantially all recourse to substantially all nonrecourse, or vice versa. 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. The final regulations also provide two exceptions. First, 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. Second, a defeasance of a tax-exempt bond permitted by the terms of the instrument generally is not a significant modification.

#### E. Rules of application

The rules of application in the final regulations are similar to those in the proposed regulations. In general, the final regulations treat a series of changes of an instrument over time as a single change. To avoid the need to retain information for all modifications that affect yield over the life of the debt instrument, however, the final regulations add a rule that, for changes in the yield, modifications occurring more than five years earlier are disregarded.

The final regulations do not adopt the suggestion of commentators that the rules in § 1.1001-3 should not apply to tax-exempt bonds. These commentators stated that, as a result of an intervening change in the Internal Revenue Code (Code) or regulations, a significant modification could result in bonds that were tax-exempt when issued ceasing to be tax-exempt bonds. Because many changes in the Code and regulations have been made applicable to refunding bonds, it is appropriate that changes to outstanding tax-exempt bonds that are, in substance, the equivalent of refund-

ings be treated as such. The IRS and Treasury believe that the standards used under § 1.1001-3 generally are appropriate for this purpose.

In response to other comments, a number of changes have been made to better coordinate the final regulations with municipal financing practices. The regulations clarify that state and local bonds (other than those financing conduit loans) are treated as recourse obligations for purposes of determining whether a modification is significant. State and local bonds financing conduit loans are nonrecourse only if there is no recourse to either the actual issuer or the conduit borrower. In the case of bonds financing conduit loans, the final regulations clarify that the obligor of a tax-exempt bond is the entity that issues the bond and not the conduit borrower. The regulations note, however, that a transaction between a holder of a tax-exempt bond and a conduit borrower may result in an indirect modification of the tax-exempt bond.

#### F. Other matters

The preamble to the proposed regulations indicates that Notice 88-130 (1988-2 C.B. 543), which provides special rules for qualified tender bonds, will continue to apply. The final regulations continue this approach, and thus do not apply for purposes of determining whether tax-exempt bonds that are qualified tender bonds are reissued for purposes of sections 103 and 141 through 150. The IRS and Treasury are reviewing the rules of Notice 88-130 and intend to issue proposed regulations on this subject under section 150. When the final regulations are issued under section 150, the exclusion for qualified tender bonds in § 1.1001-3 will be revised or eliminated as appropriate.

Also, as noted in the preamble to the proposed regulations, a modification of a debt instrument that results in an exchange under section 1001 does not determine if there has been an exchange or other disposition of an installment obligation under section 453B. Whether or not there has been an exchange or other disposition of an installment obligation is determined under the cases and rulings applicable to section 453B. Similarly, the fact that an alteration does not constitute a modification or a significant modification does not preclude other tax consequences.

Simultaneously with the issuance of these final regulations, the IRS and Treasury are issuing temporary and pro-

posed regulations under section 166. Those regulations allow taxpayers, in certain limited situations, to claim a deduction for a partially worthless debt when the terms of a debt instrument are modified. Commentators on the proposed regulations noted that section 166 permits a deduction for a partially worthless debt only in the year that the taxpayer makes a partial charge-off for book accounting purposes. A significant modification of a debt instrument that has been partially charged off may result in the recognition of gain and an increased tax basis in the instrument. Because the book charge-off is not reversed, however, the taxpayer cannot take another charge-off, and thus the taxpayer cannot meet the requirement for a deduction for a partially worthless debt under section 166. In this situation, the temporary and proposed regulations deem the charge-off to have occurred at the time of the significant modification if certain requirements are met.

#### *Effective Dates*

The final regulation applies to alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on this section for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

#### *Special Analyses*

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

#### *Drafting Information*

The principal author of these regulations is Thomas J. Kelly, Office of Assistant Chief Counsel (Financial Institutions & Products), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

#### *Adoption of Amendments to the Regulations*

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805

Par. 2. Section 1.1001-3 is added to read as follows:

#### *§ 1.1001-3 Modifications of debt instruments.*

(a) *Scope*—(1) *In general.* This section provides rules for determining whether a modification of the terms of a debt instrument results in an exchange for purposes of § 1.1001-1(a). This section applies to any modification of a debt instrument, regardless of the form of the modification. For example, this section applies to an exchange of a new instrument for an existing debt instrument, or to an amendment of an existing debt instrument. This section also applies to a modification of a debt instrument that the issuer and holder accomplish indirectly through one or more transactions with third parties. This section, however, does not apply to exchanges of debt instruments between holders.

(2) *Qualified tender bonds.* This section does not apply for purposes of determining whether tax-exempt bonds that are qualified tender bonds are reissued for purposes of sections 103 and 141 through 150.

(b) *General rule.* For purposes of § 1.1001-1(a), a significant modification of a debt instrument, within the meaning of this section, results in an exchange of the original debt instrument for a modified instrument that differs materially either in kind or in extent. A modification that is not a significant modification is not an exchange for purposes of § 1.1001-1(a). Paragraphs (c) and (d) of this section define the term *modification* and contain examples illustrating the application of the rule. Paragraphs (e) and (f) of this section provide rules for determining when a modification is a significant modification. Paragraph (g) of this section contains examples illustrating the application of the rules in paragraphs (e) and (f) of this section.

(c) *Modification defined*—(1) *In general*—(i) *Alteration of terms.* 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.

(ii) *Alterations occurring by operation of the terms of a debt instrument.* Except as provided in paragraph (c)(2) of this section, an alteration of a legal right or obligation that occurs by operation of the terms of a debt instrument is not a modification. 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.

(2) *Exceptions.* The alterations described in this paragraph (c)(2) are modifications, even if the alterations occur by operation of the terms of a debt instrument.

(i) *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.

(ii) *Property 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 (notwithstanding paragraph (c)(2)(iii) of this section).

(iii) *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—

(A) The option is unilateral (as defined in paragraph (c)(3) of this section); and

(B) 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.

(3) *Unilateral option.* For purposes of this section, an option is unilateral only

if, under the terms of an instrument or under applicable law—

(i) 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 instrument or put the instrument to a person who is related (within the meaning of section 267(b) or section 707(b)(1)) to the issuer;

(ii) The exercise of the option does not require the consent or approval of—

(A) The other party;

(B) A person who is related to that party (within the meaning of section 267(b) or section 707(b)(1)), whether or not that person is a party to the instrument; or

(C) A court or arbitrator; and

(iii) 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 (as defined in § 1.446-3(c)(4)(ii)).

(4) *Failure to perform*—(i) *In general.* The failure of an issuer to perform its obligations under a debt instrument is not itself an alteration of a legal right or obligation and is not a modification.

(ii) *Holder's temporary forbearance.* Notwithstanding paragraph (c)(1) of this section, 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—

(A) Two years following the issuer's initial failure to perform; and

(B) Any additional period during which the parties conduct good faith negotiations or during which the issuer is in a title 11 or similar case (as defined in section 368(a)(3)(A)).

(5) *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.

(6) *Time of modification*—(i) *In general.* Except as provided in this paragraph (c)(6), 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.

(ii) *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.

(iii) *Bankruptcy proceedings.* If a change in a term of a debt instrument occurs pursuant to a plan of reorganization in a title 11 or similar case (within the meaning of section 368(a)(3)(A)), a modification occurs upon the effective date of the plan. Thus, unless the plan becomes effective, a modification does not occur.

(d) *Examples.* The following examples illustrate the provisions of paragraph (c) of this section:

*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 described in paragraph (c)(2) of this section. Thus, the reset of the interest rate is not a modification.

*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 described in paragraph (c)(2) of this section. Thus, such a substitution of collateral is not a modification.

*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 described in paragraph (c)(2) of this section. Thus, such a decrease in the interest rate is not a modification.

*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. Under paragraph (c)(2)(i) of this section, the substitution of a new obligor, even though it occurs by operation of the terms of the bond, is a modification.

*Example 5. Defeasance with release of covenants.* (i) 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 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. Under paragraph (c)(3) of this section, the option to defease the bond is a unilateral option.

(ii) The alterations occur by operation of the terms of the debt instrument and are not described in paragraph (c)(2) of this section. Thus, such a release of the covenants is not a modification.

*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 described in paragraph (c)(2)(i) of this section, and thus is a modification.

*Example 7. Exercise of an option by a holder that reduces amounts payable.* (i) 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.

(ii) 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 described in paragraph (c)(2)(iii) of this section. Thus, the change in interest rate is a modification.

*Example 8. Conversion of adjustable rate to fixed rate mortgage.* (i) 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.

(ii) Because the required consideration to exercise the option is a specified amount fixed on the issue date, the exercise of the option is unilateral as defined in paragraph (c)(3) of this section. The conversion to a fixed rate of interest is not an alteration described in paragraph (c)(2) of this section. Thus, the change in the type of interest rate occurs by operation of the terms of the instrument and is not a modification.

*Example 9. Holder's option to increase interest rate.* (i) 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 as described in paragraph (c)(3) of this section.

(ii) The credit rating of the corporation declines below the specified level. The bank 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 in paragraph (c)(2) of this section. Thus, the change in interest rate is not a modification.

*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.

*Example 11. Holder's option to grant deferral of payment.* (i) 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.

(ii) 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, under paragraph (c)(3)(i) of this section, is not a unilateral option. Thus, the alteration is described in paragraph (c)(2)(iii) of this section and is a modification.

*Example 12. Alteration 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 (as defined in paragraph (c)(3) of this section) and is a modification.

*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. Under paragraph (c)(4)(ii) of this section, 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.

(e) *Significant modifications.* Whether the modification of a debt instrument is a significant modification is determined under the rules of this paragraph (e). Paragraph (e)(1) of this section provides a general rule for determining the significance of modifications not otherwise addressed in this paragraph (e). Paragraphs (e)(2) through (6) of this section provide specific rules for determining

the significance of certain types of modifications. Paragraph (f) of this section provides rules of application, including rules for modifications that are effective on a deferred basis or upon the occurrence of a contingency.

(1) *General rule.* Except as otherwise provided in paragraphs (e)(2) through (e)(6) of this section, 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. In making a determination under this paragraph (e)(1), all modifications to the debt instrument (other than modifications subject to paragraphs (e)(2) through (6) of this section) 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.

(2) *Change in yield—(i) Scope of rule.* This paragraph (e)(2) applies to debt instruments that provide for only fixed payments, debt instruments with alternative payment schedules subject to § 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 instrument) is a significant modification is determined under paragraph (e)(1) of this section.

(ii) *In general.* A change in the yield of a debt instrument is a significant modification if the yield computed under paragraph (e)(2)(iii) of this section varies from the annual yield on the unmodified instrument (determined as of the date of the modification) by more than the greater of—

(A)  $\frac{1}{4}$  of one percent (25 basis points); or

(B) 5 percent of the annual yield of the unmodified instrument ( $.05 \times$  annual yield).

(iii) *Yield of the modified instrument—(A) In general.* The yield computed under this paragraph (e)(2)(iii) is the annual yield of a debt instrument with—

(I) 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 pay-

ments 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.

(B) *Prepayment penalty.* For purposes of this paragraph (e)(2)(iii), a commercially reasonable prepayment penalty for a pro rata prepayment (as defined in § 1.1275-2(f)) is not consideration for a modification of a debt instrument and is not taken into account in determining the yield of the modified instrument.

(iv) *Variable rate debt instruments.* For purposes of this paragraph (e)(2), the annual yield of a variable rate debt instrument is the annual yield of the equivalent fixed rate debt instrument (as defined in § 1.1275-5(e)) which is constructed based on the terms of the instrument (either modified or unmodified, whichever is applicable) as of the date of the modification.

(3) *Changes in timing of payments—*

(i) *In general.* 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.

(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. For purposes of this paragraph (e)(3)(ii), 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.

(4) *Change in obligor or security*—(i) *Substitution of a new obligor on recourse debt instruments*—(A) *In general.* Except as provided in paragraph (e)(4)(i)(B), (C), or (D) of this section, the substitution of a new obligor on a recourse debt instrument is a significant modification.

(B) *Section 381(a) transaction.* 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.

(C) *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.

(D) *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.

(E) *Significant alteration.* For purposes of this paragraph (e)(4), 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.

(F) *Section 338 election.* For purposes of this section, 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.

(G) *Bankruptcy proceedings.* For purposes of this section, the filing of a petition in a title 11 or similar case (as defined in section 368(a)(3)(A)) by itself does not result in the substitution of a new obligor.

(ii) *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.

(iii) *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 paragraph (e)(4)(i)) of this section rather than as an addition or deletion of a co-obligor.

(iv) *Change in security or credit enhancement*—(A) *Recourse debt instruments.* A modification that releases, substitutes, adds or otherwise alters the collateral for, a guarantee on, 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.

(B) *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. 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). 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.

(v) *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.

(vi) *Change in payment expectations*—(A) *In general.* For purposes of this section, a change in payment expectations occurs if, as a result of a transaction—

(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 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.

(B) *Obligor's capacity.* The obligor's capacity includes any source for payment, including collateral, guarantees, or other credit enhancement.

(5) *Changes in the nature of a debt instrument*—(i) *Property that is not debt.* 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. For purposes of this paragraph (e)(5)(i), any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.

(ii) *Change in recourse nature*—(A) *In general.* Except as provided in paragraph (e)(5)(ii)(B) of this section, 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. Thus, 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 paragraph (e)(1) of this section.

(B) *Exceptions*—(1) *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.

(2) *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 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.

(6) *Accounting or financial covenants.* A modification that adds, deletes, or alters customary accounting or financial covenants is not a significant modification.

(f) *Rules of application*—(1) *Testing for significance*—(A) *In general.* Whether a modification of any term is a significant modification is determined under each applicable rule in paragraphs (e)(2) through (6) of this section and, if not specifically addressed in those rules, under the general rule in paragraph (e)(1) of this section. For example, a deferral of payments that changes the yield of a fixed rate debt instrument must be tested under both paragraphs (e)(2) and (3) of this section.

(B) *Contingent modifications.* If a modification described in paragraphs (e)(2) through (5) of this section is effective only upon the occurrence of a substantial contingency, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e)(2) through (5) of this section.

(C) *Deferred modifications.* If a modification described in paragraphs (e)(4) and (5) of this section is effective on a substantially deferred basis, whether or not the change is a significant modification is determined under paragraph (e)(1) of this section rather than under paragraphs (e)(4) and (5) of this section.

(2) *Modifications that are not significant.* If a rule in paragraphs (e)(2) through (4) of this section 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 paragraph (e)(2) of this section. Likewise, if a rule in paragraph (e)(4) of this section requires a change in payment expectations

for a modification 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.

(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 under paragraph (e) of this section. 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 under paragraph (e) of this section. In testing for a change of yield under paragraph (e)(2) of this section, however, any prior modification occurring more than 5 years before the date of the modification being tested is disregarded.

(4) *Modifications of different terms.* Modifications of different terms of a debt instrument, none of which separately would be a significant modification under paragraphs (e)(2) through (6) of this section, do not collectively constitute a significant modification. For example, a change in yield that is not a significant modification under paragraph (e)(2) of this section and a substitution of collateral that is not a significant modification under paragraph (e)(4)(iv) of this section 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.

(5) *Definitions.* For purposes of this section:

(i) *Issuer* and *obligor* are used interchangeably and mean the issuer of a debt instrument or a successor obligor.

(ii) *Variable rate debt instrument* and *contingent payment debt instrument* have the meanings given those terms in section 1275 and the regulations thereunder.

(iii) *Tax-exempt bond* means a state or local bond that satisfies the requirements of section 103(a).

(iv) *Conduit loan* and *conduit borrower* have the same meanings as in § 1.150-1(b).

(6) *Certain rules for tax-exempt bonds*—(i) *Conduit loans.* For purposes

of this section, 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 under paragraph (a)(1) of this section. 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.

(ii) *Recourse nature*—(A) *In general.* For purposes of this section, a tax-exempt bond that does not finance a conduit loan is a recourse debt instrument.

(B) *Proceeds used for conduit loans.* For purposes of this section, 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.

(C) *Government securities as collateral.* Notwithstanding paragraphs (f)(6)(ii)(A) and (B) of this section, for purposes of this section a tax-exempt bond that is secured only by a trust holding 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.

(g) *Examples.* The following examples illustrate the provisions of paragraphs (e) and (f) of this section:

*Example 1. Modification of call right.* (i) 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 rating is approximately the same as when the bond was issued, but market rates of interest have declined from that date.

(ii) 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 change in yield as described in paragraph (e)(2)(ii) of this section.

(iii) 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 of paragraphs (e)(2) through (e)(6) of this section do not address this modification, the significance of the modification must be determined under the general rule of paragraph (e)(1) of this section.

*Example 2. Extension of maturity and change in yield.* (i) 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).

(ii) The deferral of the scheduled payment at maturity is tested under paragraph (e)(3) of this section. The safe-harbor period under paragraph (e)(3)(ii) of this section 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 of paragraph (e)(3)(ii) of this section and thus is not a significant modification.

(iii) Even though the extension of maturity is not a significant modification under paragraph (e)(3)(ii) of this section, the modification also decreases the yield of the bond. The change in yield must be tested under paragraph (e)(2) of this section.

*Example 3. Change in yield resulting from reduction of principal.* (i) 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.

(ii) In applying the change in yield rule of paragraph (e)(2) of this section, 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 paragraph (e)(2)(i) of this section is 4.332 percent. Thus, the reduction in principal is a significant modification.

*Example 4. Deferral of scheduled interest payments.* (i) 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.

(ii) The safe-harbor period of paragraph (e)(3)(ii) of this section 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.

(iii) This modification materially defers the payments due under the instrument and is a significant modification under paragraph (e)(3)(i) of this section.

*Example 5. Assumption of mortgage with increase in interest rate.* (i) A recourse debt instrument with a 9 percent annual yield is secured by an office building. Under the terms of the instru-

ment, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser has a specified credit rating 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.

(ii) If the purchaser's acquisition of the building does not satisfy the requirements of paragraphs (e)(4)(i)(B) or (C) of this section, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) 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.

(iv) The change in the interest rate, if tested under the rules of paragraph (e)(2) of this section, would result in a significant modification. The change in interest rate that results from the transaction is a significant alteration. Thus, the transaction does not meet the requirements of paragraph (e)(4)(i)(E) of this section and is a significant modification under paragraph (e)(4)(i)(A) of this section.

*Example 6. Assumption of mortgage.* (i) 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.

(ii) The transaction does not satisfy any of the exceptions set forth in paragraph (e)(4)(i)(B) or (C) of this section. Thus, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) 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.

*Example 7. Substitution of a new obligor in section 381(a) transaction.* (i) 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.

(ii) 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 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.

(iii) 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 under paragraph (e)(4)(i)(E) of this section. Thus, the substitution meets the

requirements of paragraph (e)(4)(i)(B) of this section and is not a significant modification.

*Example 8. Substitution of credit enhancement contract.* (i) 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 and rating agencies lower its credit rating. The issuer and holder agree that the issuer will substitute a letter of credit from another bank with a higher credit rating.

(ii) Under paragraph (e)(4)(iv)(A) of this section, 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 bank with a higher credit rating 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).

*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 paragraph (e)(4)(iv)(B) of this section.

(h) *Effective date.* This section applies to alterations of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on this section for alterations of the terms of a debt instrument after December 2, 1992, and before September 24, 1996.

Margaret Milner Richardson,  
*Commissioner of Internal Revenue.*

Approved:

Leslie Samuels,  
*Assistant Secretary of the Treasury.*

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