Reg. Section 1.1001-3(a)(1)

(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. 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 (f) of this section also provides rules for determining whether the modified instrument received in an exchange will be classified as an instrument or property right that is not debt for federal income tax purposes. 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). The rules of paragraph (f)(7) of this section apply to determine whether an alteration or modification results in an instrument or property right that is not debt.

(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 if certain covenants in the note are breached. The bank's right to increase the interest rate is a unilateral option as described in paragraph (c)(3) of this section.

(ii) A covenant in the note is breached. 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.

(iii) Applicability date. This Example 9 applies to modifications occurring on or after July 6, 2011.

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) ¼ of one percent (25 basis points); or

(B) 5 percent of the annual yield of the unmodified instrument (.05 × 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-

(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.

(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.

(1) 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 credit quality). 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.

(2) Applicability date. Paragraph (e)(4)(iv)(B)(1) of this section applies to modifications occurring on or after July 6, 2011.

(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. The rules of paragraph (f)(7) of this section apply to determine whether a modification results in an instrument or property right that is not debt.

(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.

(i) 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 credit quality), 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.

(ii) Applicability date. Paragraph (e)(5)(ii)(B)(2)(i) of this section applies to modifications occurring on or after July 6, 2011.

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

. . .