

=====

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9513
RIN 1545-BJ30

Modifications of Debt Instruments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations relating to the modification of debt instruments. The regulations clarify the extent to which the deterioration in the financial condition of the issuer is taken into account to determine whether a modified debt instrument will be recharacterized as an instrument or property right that is not debt. The regulations provide needed guidance to issuers and holders of debt instruments.

DATES: Effective Date: These regulations are effective on January 7, 2011.

Applicability Date: For dates of applicability, see Sec. 1.1001-3(h).

FOR FURTHER INFORMATION CONTACT: Diana Imholtz at (202) 622-3920 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On June 4, 2010, a notice of proposed rulemaking (REG-106750-10, 2010-25 IRB 765) was published in the Federal Register (75 FR 31736) that proposed amendments to Sec. 1.1001-3 to clarify the circumstances in which the credit quality of the issuer should be considered in determining the nature of the instrument resulting from an alteration or modification of a debt instrument. Because no requests to speak were submitted by

August 11, 2010, no public hearing was held. One written comment was received in response to the notice of proposed rulemaking. After consideration of this comment, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed in this preamble.

Explanation and Summary of Comments

The only comment received on the proposed regulations requested that the regulations clarify that Sec. 1.1001-3 applies not only to determine whether an exchange of the original debt instrument for a modified instrument has occurred but also to classify the modified instrument resulting from the exchange. The IRS and the Treasury Department intend that Federal income tax principles be used to determine the classification of a modified instrument resulting from an exchange except as specifically provided in Sec. 1.1001-3(f)(7). To avoid doubt on the operation of the rules in the proposed regulations, the final regulations add language to the general rule of Sec. 1.1001-3(b) to make clear that the rules provided in Sec. 1.1001-3(f)(7) apply to determine whether the modified instrument received in an exchange will be classified as debt for Federal income tax purposes. Thus, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor, all relevant factors (for example, creditor rights or subordination) other than any deterioration in the financial condition of the issuer are taken into account in determining whether a modified instrument is properly classified as debt for Federal income tax purposes.

Effective/Applicability Date

The regulations apply to alterations of the terms of a debt instrument on or after January 7, 2011. A taxpayer, however, may rely on Sec. 1.1001-3(f)(7) for alterations of the terms of a debt instrument occurring before that date.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these final regulations is Diana Imholtz, Office of Associate Chief Counsel (Financial Institutions & Products), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of the Amendments to the Regulations

0

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

0

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

Authority: 26 U.S.C. 7805 * * *

0

Par. 2. Section 1.1001-3 is amended by:

0

1. Revising paragraphs (b), (c)(2)(ii), (e)(5)(i) and (h).

0

2. Adding paragraph (f)(7).

The revisions and addition read as follows:

Sec. 1.1001-3 Modifications of debt instruments.

* * * * *

(b) General rule. For purposes of Sec. 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 Sec. 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) * * *

(2) * * *

(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.

* * * * *

(e) * * *

(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.

* * * * *

(f) * * *

(7) Rules for determining whether an alteration or modification results in an instrument or property right that is not debt--(i) In general. Except as provided in paragraph (f)(7)(ii) of this section, the determination of whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt for Federal income tax purposes shall take into account all of the factors relevant to such a determination.

(ii) Financial condition of the obligor--(A) Deterioration in financial condition of the obligor generally disregarded. Except as provided in paragraph (f)(7)(ii)(B) of this section, in making a determination as to whether an instrument resulting from an alteration or modification of a debt instrument will be recharacterized as an instrument or property right that is not debt, any deterioration in the financial condition of the obligor between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the obligor's ability to repay the debt instrument) is not taken into account. For example, any decrease in the fair market value of a debt instrument (whether or not the debt instrument is publicly traded) between the issue date of the debt instrument and the date of the alteration or modification is not taken into account to the extent that the decrease in fair market value is attributable to the deterioration in the financial condition of the obligor and not to a modification of the terms of the instrument.

(B) Substitution of a new obligor; addition or deletion of co-obligor. If there is a substitution of a new obligor or the addition or deletion of a co-obligor, the rules in paragraph (f)(7)(ii)(A) of this section do not apply.

* * * * *

(h) Effective/applicability date--(1) In general. Except as otherwise provided in paragraph (h)(2) of this section, 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.

(2) Exception. Paragraph (f)(7) of this section applies to an alteration of the terms of a debt instrument on or after January 7, 2011. A taxpayer, however, may rely on paragraph (f)(7) of this section for alterations of the terms of a debt instrument occurring before that date.

Steven T. Miller,
Deputy Commissioner for Services and Enforcement.

Approved: December 21, 2010.

Michael Mundaca,
Assistant Secretary of the Treasury (Tax Policy).