

SUBCHAPTER A—INCOME TAX (Continued)

PART 1—INCOME TAXES (Continued)

Normal Taxes and Surtaxes (continued)

GAIN OR LOSS ON DISPOSITION OF PROPERTY

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AUTHORITY: 26 U.S.C. 7805, unless otherwise noted.

- Section 1.1060-1T also issued under 26 U.S.C. 1060.
- Sections 1.1092(b)-1T and 1.1092(b)-2T also issued under 26 U.S.C. 1092 (b)(1).
- Section 1.1092(b)-4T also issued under 26 U.S.C. 1092(b)(2).
- Section 1.1092(d)-2 also issued under 26 U.S.C. 1092(d)(3)(B).
- Section 1.1221-2 also issued under 26 U.S.C. 1502 and 6001.
- Section 1.1244(e)-1 also issued under 26 U.S.C. 1244(e).
- Section 1.1254-1 also issued under 26 U.S.C. 1254(b).
- Section 1.1254-2 also issued under 26 U.S.C. 1254(b).
- Section 1.1254-3 also issued under 26 U.S.C. 1254(b).
- Section 1.1254-4 also issued under 26 U.S.C. 1254(b).
- Section 1.1254-5 also issued under 26 U.S.C. 1254(b).
- Section 1.1254-6 also issued under 26 U.S.C. 1254(b).
- Sections 1.1271-1 through 1.1274-5 also issued under 26 U.S.C. 1275(d).
- Section 1.1274A-1 also issued under 26 U.S.C. 1274A(e) and 26 U.S.C. 1275(d).
- Sections 1.1275-1 through 1.1275-5 also issued under 26 U.S.C. 1275(d).
- Section 1.1275-6 also issued under 26 U.S.C. 1275(d).
- Section 1.1275-7T also issued under 26 U.S.C. 1275(d).
- Section 1.1286-1 also issued under 26 U.S.C. 1275(D) and 1286(f).
- Section 1.1286-2T also issued under 26 U.S.C. 1286(f).
- Section 1.1287-1 also issued under 26 U.S.C. 165 (j)(3).
- Section 1.1291-9 also issued under 26 U.S.C. 1291(d)(2).
- Section 1.1291-10 also issued under 26 U.S.C. 1291(d)(2).
- Section 1.1294-1T also issued under 26 U.S.C. 1294.
- Section 1.1297-3T also issued under 26 U.S.C. 1297(b)(1).
- Section 1.1361-1(j) (6), (10) and (11) also issued under 26 U.S.C. 1361(d)(2)(B)(iii).
- Section 1.1361-1(l) also issued under 26 U.S.C. 1361(c)(5)(C).
- Sections 1.1362-1, 1.1362-2, 1.1362-3, 1.1362-4, 1.1362-5, 1.1362-6, 1.1362-7, and 1.1363-1 also issued under 26 U.S.C. 1377.
- Section 1.1368-1(f) and (g) also issued under 26 U.S.C. 1377(c).
- Section 1.1368-2(b) also issued under 26 U.S.C. 1368(c).

Internal Revenue Service, Treasury

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Section 1.1374-1 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-2 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-3 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-4 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-5 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-6 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-7 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-8 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-9 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1374-10 also issued under 26 U.S.C. 1374(e) and 337(d).
Section 1.1377-1 also issued under 26 U.S.C. 1377(a)(2) and (c).
Section 1.1394-1 also issued under 26 U.S.C. 1397D.

SOURCE: T.D. 6500, 25 FR 11910, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, unless otherwise noted.

**GAIN OR LOSS ON DISPOSITION OF
PROPERTY**

DETERMINATION OF AMOUNT OF AND
RECOGNITION OF GAIN OR LOSS

§1.1001-1 Computation of gain or loss.

(a) *General rule.* Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained. The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of any property (other than money) received. The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value. The general method of computing such gain or loss is prescribed by section 1001 (a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and the regulations thereunder (*i.e.*, the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized. The basis may be different depending upon whether gain or loss is being computed. For example, see section 1015(a) and the regulations thereunder. Section 1001(e) and paragraph (f) of this section prescribe the method of computing gain or loss upon the sale or other disposition of a term interest in property the adjusted basis (or a portion) of which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to

the basis of property acquired by gift or by a transfer in trust).

(b) *Real estate taxes as amounts received.* (1) Section 1001(b) and section 1012 state rules applicable in making an adjustment upon a sale of real property with respect to the real property taxes apportioned between seller and purchaser under section 164(d). Thus, if the seller pays (or agrees to pay) real property taxes attributable to the real property tax year in which the sale occurs, he shall not take into account, in determining the amount realized from the sale under section 1001(b), any amount received as reimbursement for taxes which are treated under section 164(d) as imposed upon the purchaser. Similarly, in computing the cost of the property under section 1012, the purchaser shall not take into account any amount paid to the seller as reimbursement for real property taxes which are treated under section 164(d) as imposed upon the purchaser. These rules apply whether or not the contract of sale calls for the purchaser to reimburse the seller for such real property taxes paid or to be paid by the seller.

(2) On the other hand, if the purchaser pays (or is to pay) an amount representing real property taxes which are treated under section 164(d) as imposed upon the seller, that amount shall be taken into account both in determining the amount realized from the sale under section 1001(b) and in computing the cost of the property under section 1012. It is immaterial whether or not the contract of sale specifies that the sale price has been reduced by, or is in any way intended to reflect, the taxes allocable to the seller. See also paragraph (b) of §1.1012-1.

(3) Subparagraph (1) of this paragraph shall not apply to a seller who, in a taxable year prior to the taxable year of sale, pays an amount representing real property taxes which are treated under section 164(d) as imposed on the purchaser, if such seller has elected to capitalize such amount in accordance with section 266 and the regulations thereunder (relating to election to capitalize certain carrying charges and taxes).

(4) The application of this paragraph may be illustrated by the following examples:

Example 1. Assume that the contract price on the sale of a parcel of real estate is \$50,000 and that real property taxes thereon in the amount of \$1,000 for the real property tax year in which occurred the date of sale were previously paid by the seller. Assume further that \$750 of the taxes are treated under section 164(d) as imposed upon the purchaser and that he reimburses the seller in that amount in addition to the contract price. The amount realized by the seller is \$50,000. Similarly, \$50,000 is the purchaser's cost. If, in this example, the purchaser made no payment other than the contract price of \$50,000, the amount realized by the seller would be \$49,250, since the sales price would be deemed to include \$750 paid to the seller in reimbursement for real property taxes imposed upon the purchaser. Similarly, \$49,250 would be the purchaser's cost.

Example 2. Assume that the purchaser in example (1), above, paid all of the real property taxes. Assume further that \$250 of the taxes are treated under section 164(d) as imposed upon the seller. The amount realized by the seller is \$50,250. Similarly, \$50,250 is the purchaser's cost, regardless of the taxable year in which the purchaser makes actual payment of the taxes.

Example 3. Assume that the seller described in the first part of example (1), above, paid the real property taxes of \$1,000 in the taxable year prior to the taxable year of sale and elected under section 266 to capitalize the \$1,000 of taxes. In such a case, the amount realized is \$50,750. Moreover, regardless of whether the seller elected to capitalize the real property taxes, the purchaser in that case could elect under section 266 to capitalize the \$750 of taxes treated under section 164(d) as imposed upon him, in which case his adjusted basis would be \$50,750 (cost of \$50,000 plus capitalized taxes of \$570).

(c) *Other rules.* (1) Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the property exceeds such basis. Except as otherwise provided in section 301(c)(3)(B) with respect to distributions out of increase in value of property accrued prior to March 1, 1913, such gain is includible in gross income under section 61 as "income from whatever source derived". On the other hand, a loss is not ordinarily sustained prior to the sale or other disposition of

the property, for the reason that until such sale or other disposition occurs there remains the possibility that the taxpayer may recover or recoup the adjusted basis of the property. Until some identifiable event fixes the actual sustaining of a loss and the amount thereof, it is not taken into account.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. A, an individual on a calendar year basis, purchased certain shares of stock subsequent to February 28, 1913, for \$10,000. On January 1, 1954, A's adjusted basis for the stock had been reduced to \$1,000 by reason of receipts and distributions described in sections 1016(a)(1) and 1016(a)(4). He received in 1954 a further distribution of \$5,000, being a distribution covered by section 1016(a)(4), other than a distribution out of increase of value of property accrued prior to March 1, 1913. This distribution applied against the adjusted basis as required by section 1016(a)(4) exceeds that basis by \$4,000. The \$4,000 excess is a gain realized by A in 1954 and is includible in gross income in his return for that calendar year. In computing gain from the stock, as in adjusting basis, no distinction is made between items of receipts or distributions described in section 1016. If A sells the stock in 1955 for \$5,000, he realizes in 1955 a gain of \$5,000, since the adjusted basis of the stock for the purpose of computing gain or loss from the sale is zero.

(d) *Installment sales.* In the case of property sold on the installment plan, special rules for the taxation of the gain are prescribed in section 453.

(e) *Transfers in part a sale and in part a gift.* (1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015-4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see § 1.1011-2.

(2) *Examples.* The provisions of subparagraph (1) may be illustrated by the following examples:

Example 1. A transfers property to his son for \$60,000. Such property in the hands of A has an adjusted basis of \$30,000 (and a fair market value of \$90,000). A's gain is \$30,000,

the excess of \$60,000, the amount realized, over the adjusted basis, \$30,000. He has made a gift of \$30,000, the excess of \$90,000, the fair market value, over the amount realized, \$60,000.

Example 2. A transfers property to his son for \$30,000. Such property in the hands of A has an adjusted basis of \$60,000 (and a fair market value of \$90,000). A has no gain or loss, and has made a gift of \$60,000, the excess of \$90,000, the fair market value, over the amount realized, \$30,000.

Example 3. A transfers property to his son for \$30,000. Such property in A's hands has an adjusted basis of \$30,000 (and a fair market value of \$60,000). A has no gain and has made a gift of \$30,000, the excess of \$60,000, the fair market value, over the amount realized, \$30,000.

Example 4. A transfers property to his son for \$30,000. Such property in A's hands has an adjusted basis of \$90,000 (and a fair market value of \$60,000). A has sustained no loss, and has made a gift of \$30,000, the excess of \$60,000, the fair market value, over the amount realized, \$30,000.

(f) *Sale or other disposition of a term interest in property*—(1) *General rule.* Except as otherwise provided in subparagraph (3) of this paragraph, for purposes of determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in subparagraph (2) of this paragraph) a taxpayer shall not take into account that portion of the adjusted basis of such interest which is determined pursuant, or by reference, to section 1014 (relating to the basis of property acquired from a decedent) or section 1015 (relating to the basis of property acquired by gift or by a transfer in trust) to the extent that such adjusted basis is a portion of the adjusted uniform basis of the entire property (as defined in §1.1014-5). Where a term interest in property is transferred to a corporation in connection with a transaction to which section 351 applies and the adjusted basis of the term interest (i) is determined pursuant to section 1014 or 1015 and (ii) is also a portion of the adjusted uniform basis of the entire property, a subsequent sale or other disposition of such term interest by the corporation will be subject to the provisions of section 1001(e) and this paragraph to the extent that the basis of the term interest so sold or otherwise disposed of is determined by reference to its basis in the hands of the transferor as provided by section 362(a). See

subparagraph (2) of this paragraph for rules relating to the characterization of stock received by the transferor of a term interest in property in connection with a transaction to which section 351 applies. That portion of the adjusted uniform basis of the entire property which is assignable to such interest at the time of its sale or other disposition shall be determined under the rules provided in §1.1014-5. Thus, gain or loss realized from a sale or other disposition of a term interest in property shall be determined by comparing the amount of the proceeds of such sale with that part of the adjusted basis of such interest which is not a portion of the adjusted uniform basis of the entire property.

(2) *Term interest defined.* For purposes of section 1001(e) and this paragraph, a *term interest in property* means—

- (i) A life interest in property,
- (ii) An interest in property for a term of years, or
- (iii) An income interest in a trust.

Generally, subdivisions (i), (ii), and (iii) refer to an interest, present or future, in the income from property or the right to use property which will terminate or fail on the lapse of time, on the occurrence of an event or contingency, or on the failure of an event or contingency to occur. Such divisions do not refer to remainder or reversionary interests in the property itself or other interests in the property which will ripen into ownership of the entire property upon termination or failure of a preceding term interest. A *term interest in property* also includes any property received upon a sale or other disposition of a life interest in property, an interest in property for a term of years, or an income interest in a trust by the original holder of such interest, but only to the extent that the adjusted basis of the property received is determined by reference to the adjusted basis of the term interest so transferred.

(3) *Exception.* Paragraph (1) of section 1001(e) and subparagraph (1) of this paragraph shall not apply to a sale or other disposition of a term interest in property as a part of a single transaction in which the entire interest in the property is transferred to a third person or to two or more other persons,

including persons who acquire such entire interest as joint tenants, tenants by the entirety, or tenants in common. See § 1.1014-5 for computation of gain or loss upon such a sale or other disposition where the property has been acquired from a decedent or by gift or transfer in trust.

(4) *Illustrations.* For examples illustrating the application of this paragraph, see paragraph (c) of § 1.1014-5.

(g) *Debt instruments issued in exchange for property—(1) In general.* If a debt instrument is issued in exchange for property, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1273-2 or § 1.1274-2, whichever is applicable. If, however, the issue price of the debt instrument is determined under section 1273(b)(4), the amount realized attributable to the debt instrument is its stated principal amount reduced by any unstated interest (as determined under section 483).

(2) *Certain debt instruments that provide for contingent payments—(i) In general.* Paragraph (g)(1) of this section does not apply to a debt instrument subject to either § 1.483-4 or § 1.1275-4(c) (certain contingent payment debt instruments issued for nonpublicly traded property).

(ii) *Special rule to determine amount realized.* If a debt instrument subject to § 1.1275-4(c) is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is the issue price of the debt instrument as determined under § 1.1274-2(g), increased by the fair market value of the contingent payments payable on the debt instrument. If a debt instrument subject to § 1.483-4 is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, the amount realized attributable to the debt instrument is its stated principal amount, reduced by any unstated interest (as determined under section 483), and increased by the fair market value of the contingent payments payable on the debt instrument. This paragraph (g)(2)(ii), however, does not apply to a debt instrument if the fair market

value of the contingent payments is not reasonably ascertainable. Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable.

(3) *Coordination with section 453.* If a debt instrument is issued in exchange for property, and the income from the exchange is not reported under the installment method of section 453, this paragraph (g) applies rather than § 15a.453-1(d)(2) to determine the taxpayer's amount realized attributable to the debt instrument.

(4) *Effective date.* This paragraph (g) applies to sales or exchanges that occur on or after August 13, 1996.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7142, 36 FR 18950, Sept. 24, 1971; T.D. 7207, 37 FR 20797, Oct. 5, 1972; T.D. 7213, 37 FR 21992, Oct. 18, 1972; T.D. 8517, 59 FR 4807, Feb. 2, 1994; T.D. 8674, 61 FR 30139, June 14, 1996]

§ 1.1001-2 Discharge of liabilities.

(a) *Inclusion in amount realized—(1) In general.* Except as provided in paragraph (a)(2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

(2) *Discharge of indebtedness.* The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61-12(b)(1).

(3) *Liability incurred on acquisition.* In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

(4) *Special rules.* For purposes of this section—

(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(b) *Effect of fair market value of security.* The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

(c) *Examples.* The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.

Example 1. In 1976 A purchases an asset for \$10,000. A pays the seller \$1,000 in cash and signs a note payable to the seller for \$9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977, A takes depreciation deductions on the asset in the amount of \$3,100. During this same time period A reduces the outstanding principal on the note to \$7,600. At the beginning of 1978 A sells the asset. The buyer pays A \$1,600 in cash and assumes

personal liability for the \$7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is \$9,200 (\$1,600 + \$7,600). Since A's adjusted basis in the asset is \$6,900 (\$10,000 - \$3,100) A realizes a gain of \$2,300 (\$9,200 - \$6,900).

Example 2. Assume the same facts as in example (1) except that A is not personally liable on the \$9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addition, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is \$9,200 and A's gain realized is \$2,300 on the sale.

Example 3. In 1975 L becomes a limited partner in partnership GL. L contributes \$10,000 in cash to GL and L's distributive share of partnership income and loss is 10 percent. L is not entitled to receive any guaranteed payments. In 1978 M purchases L's entire interest in partnership GL. At the time of the sale L's adjusted basis in the partnership interest is \$20,000. At that time L's proportionate share of liabilities, of which no partner has assumed personal liability, is \$15,000. M pays \$10,000 in cash for L's interest in the partnership. Under section 752(d) and this section, L's share of partnership liabilities, \$15,000, is treated as money received. Accordingly, L's amount realized on the sale of the partnership interest is \$25,000 (\$10,000 + \$15,000). L's gain realized on the sale is \$5,000 (\$25,000 - \$20,000).

Example 4. In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate share of which is \$9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the \$9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) \$3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the \$9,000 of liabilities is treated by B as money received, thereby making B's amount realized \$9,000. B's gain realized is \$6,000 (\$9,000 - \$3,000).

Example 5. In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is \$1,200, C renounces the powers

previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is \$11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a "grantor trust". However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities (\$11,000) is treated as money received. Accordingly, C's amount realized is \$11,000 and C's gain realized is \$9,800 (\$11,000 - \$1,200).

Example 6. In 1977 D purchases an asset for \$7,500. D pays the seller \$1,500 in cash and signs a note payable to the seller for \$6,000. D is not personally liable for repayment but pledges as security the newly purchased asset. In the event of default, the seller's only recourse is to the asset. During the years 1977 and 1978 D takes depreciation deductions on the asset totaling \$4,200 thereby reducing D's basis in the asset to \$3,300 (\$7,500 - \$4,200). In 1979 D transfers the asset to a trust which is not a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the Code. Therefore D is not treated as the owner of the trust. The trust takes the asset subject to the liability and in addition pays D \$750 in cash. Prior to the transfer D had reduced the amount outstanding on the liability to \$4,700. D's amount realized on the transfer is \$5,450 (\$4,700 + \$750). Since D's adjusted basis is \$3,300, D's gain realized is \$2,150 (\$5,450 - \$3,300).

Example 7. In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is \$20,000 consisting of \$1,000 cash and a \$19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is \$15,000 and the remaining principal balance on the note is \$19,000. At that time E's adjusted basis in the herd is \$16,500 due to a de-

ductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is \$19,000 notwithstanding the fact that the fair market value of the herd was less than \$19,000. E's realized gain is \$2,500 (\$19,000 - \$16,500).

Example 8. In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 (\$7,500 - \$6,000).

[T.D. 7741, 45 FR 81744, Dec. 12, 1980]

§ 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