§ 1.1001–3T Modifications of debt instruments (temporary).

(a) through (d) *Example 8* [Reserved] For further guidance, see § 1.1001–3(a) through (d) *Example 8*.

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 § 1.1001–3(c)(3).

(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 § 1.1001–3(c)(2). Thus, the change in interest rate is not a modification.

(iii) *Effective/applicability date.* This *Example 9* applies to modifications occurring on or after July 6, 2011.

(d) *Example 10* through (e)(4)(iv)(A) [Reserved] For further guidance, see § 1.1001–3(d) *Example 10* through (e)(4)(iv)(A).

(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*) *Effective/applicability date.* This paragraph (e)(4)(iv)(B) applies to modifications occurring on or after July 6, 2011.

(e)(4)(v) through (e)(5)(ii)(B)(*1*) [Reserved] For further guidance, see § 1.1001–3(e)(4)(v) through (e)(5)(ii)(B)(*1*).

(*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*) *Effective/applicability date.* This paragraph (e)(5)(ii)(B)(*2*) applies to modifications occurring on or after July 6, 2011.

(e)(6) through (g) introductory text [Reserved] For further guidance, see § 1.1001–3(e)(6) through (g) introductory text.

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 quality 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 § 1.1001–3(e)(2)(ii).

(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 § 1.1001–3(e)(2) through (e)(6) do not address this modification, the significance of the modification must be determined under the general rule of § 1.1001–3(e)(1).

(iv) *Effective/applicability date.* This *Example 1* applies to modifications occurring on or after July 6, 2011.

Example 2 through *Example 4* [Reserved] For further guidance, see § 1.1001–3(g) *Example 2* through *Example 4*.

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 instrument, a purchaser of the building may assume the debt and be substituted for the original obligor if the purchaser is equally or more creditworthy than the original obligor and if the interest rate on the instrument is increased by one-half percent (50 basis points). The building is sold, the purchaser assumes the debt, and the interest rate increases by 50 basis points.

(ii) If the purchaser's acquisition of the building does not satisfy the requirements of §1.1001–3(e)(4)(i)(B) or (C), the substitution of the purchaser as the obligor is a significant modification under §1.1001–3(e)(4)(i)(A).

(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 §1.1001–3(e)(2), 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 §1.1001–3(e)(4)(i)(C) and is a significant modification under §1.1001–3 (e)(4)(i)(A).

(v) *Effective/applicability date.* Notwithstanding §1.1001–3(h), this *Example 5* applies to modifications occurring on or after July 6, 2011.

Example 6 through *Example 7* [Reserved] For further guidance, see §1.1001–3(g) *Example 6* through *Example 7*.

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. The issuer and holder agree that the issuer will substitute a letter of credit from another bank.

(ii) Under §1.1001–3(e)(4)(iv)(A), the substitution of a different credit enhancement contract is not a significant modification of a recourse debt instrument unless the substitution results in a change in payment expectations. While the substitution of a new letter of credit by a different bank does not itself result in a change in payment expectations, such a substitution may result in a change in payment expectations under certain circumstances (for example, if the obligor's capacity to meet payment obligations is dependent on the letter of credit and the substitution substantially enhances that capacity from primarily speculative to adequate).

(iii) *Effective/applicability date.* This *Example 8* applies to modifications occurring on or after July 6, 2011.

Example 9 through (h) [Reserved] For further guidance, see §1.1001–3(g) *Example 9* through (h).

(i) *Expiration date.* The applicability of this section expires on or before July 1, 2014.

[T.D. 9533, 76 FR 39282, July 6, 2011]

§ 1.1001–4 Modifications of certain derivative contracts.

(a) through (d) [Reserved] For further guidance, see §1.1001–4T(a) through (d).

[T.D. 9538, 76 FR 43893, July 22, 2011]

§ 1.1001–4T Modifications of certain derivative contracts (temporary).

(a) *Certain assignments.* For purposes of §1.1001–1(a), the transfer or assignment of a derivative contract is not treated by the nonassigning counterparty as a deemed exchange of the original contract for a modified contract that differs materially either in kind or in extent if—

(1) Both the party transferring or assigning its rights and obligations under the derivative contract and the party to which the rights and obligations are transferred or assigned are either a dealer or a clearinghouse;

(2) The terms of the derivative contract permit the transfer or assignment of the contract, whether or not the consent of the nonassigning counterparty is required for the transfer or assignment to be effective; and

(3) The terms of the derivative contract are not otherwise modified in a manner that results in a taxable exchange under section 1001.

(b) *Definitions*—(1) *Dealer.* For purposes of this section, a *dealer* is a taxpayer who meets the definition of a dealer in securities in section 475(c)(1) or is a dealer in commodities derivative contracts.

(2) *Clearinghouse.* For purposes of this section, a *clearinghouse* is a derivatives clearing organization (as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a)) or a clearing agency (as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a))) that is