

[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-106750-10]

RIN 1545-BJ30

Modifications of Debt Instruments

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed 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. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by **[INSERT DATE 60 DAYS**

**AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Outlines of topics to be discussed at the public hearing scheduled for Wednesday,

September 8, 2010, at 10 a.m. must be received by Wednesday, August 11, 2010.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-106750-10), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044.

Submissions may be hand-delivered Monday through Friday between the hours of 8

a.m. and 4 p.m. to CC:PA:LPD:PR (REG-106750-10), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, DC, or sent electronically, via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS and REG-106750-10).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Diana Imholtz, at (202) 622-3930; concerning submission of comments, the hearing, and/or to be placed on the building access list to attend the hearing,

Richard.A.Hurst@irsounsel.treas.gov, at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### **Background**

Section 1.1001-3 provides rules for determining when a modification of a debt instrument results in an exchange for purposes of §1.1001-1(a). In general, §1.1001-3 defines a modification and provides that a modification that is significant results in a deemed exchange of the original debt instrument for a modified debt instrument.

Section 1.1001-3 also addresses alterations to the terms of a debt instrument that result in a modified instrument that is not debt. Section 1.1001-3(c)(2)(ii) generally provides that a modification to a debt instrument occurs if an alteration changes the instrument to an instrument or property right that is not debt for federal income tax purposes, even if the alteration occurs by operation of the original terms of the debt instrument. Section 1.1001-3(e)(5)(i) generally provides that 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 making the determination prescribed by §1.1001-3(e)(5)(i), the regulations state that any deterioration in the financial condition of the issuer between the issue date of the unmodified debt instrument and the date of

modification (as it relates to the issuer's obligation to repay the debt instrument) is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor.

In response to the proposed regulations published on December 2, 1992 (57 FR 57034), taxpayers were concerned that taking into account the creditworthiness of a financially troubled issuer when a debt instrument is modified would impose a significant barrier to restructuring distressed debt instruments. The rule in §1.1001-3(e)(5)(i) to disregard the financial condition of the issuer was intended to address this concern. The preamble to the existing regulations published on September 24, 1996 (TD 8675; 61 FR 32926) explains 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 language in the preamble to the existing regulations suggests that for *all* purposes of §1.1001-3 the financial deterioration of the issuer is generally not taken into account. Issuers and holders, however, are concerned that, as the existing regulations are currently drafted, a decline in the creditworthiness of the issuer, under certain circumstances, may be taken into account under §1.1001-3. The uncertainty about the proper interpretation of the existing regulations has led taxpayers to request clarification on 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. Accordingly, the IRS and the Treasury Department believe it is appropriate to propose amendments to §1.1001-3 to clarify this issue.

## **Explanation of Provisions**

In general, the proposed regulations require an analysis of all of the factors relevant to a debt determination of the modified instrument at the time of an alteration or modification. However, in making this determination for purposes of the regulation, any deterioration in the financial condition of the issuer between the issue date of the debt instrument and the date of the alteration or modification (as it relates to the issuer's ability to repay the debt instrument) is not taken into account, unless there is a substitution of a new obligor or the addition or deletion of a co-obligor.

As noted in this preamble, the proposed regulations clarify that any deterioration in the financial condition of the issuer is generally not taken into account to determine if the modified instrument is debt. For example, under the proposed regulations, any decrease in the fair market value of a debt instrument (whether or not 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 issuer and not to a modification of the terms of the instrument. Consistent with this rule in the proposed regulations, if a debt instrument is significantly modified and the issue price of the modified debt instrument is determined under §1.1273-2(b) or (c) (relating to a fair market value issue price for publicly traded debt), then any increased yield on the modified debt instrument attributable to this issue price generally is not taken into account to determine whether the modified debt instrument is debt or some other property right for federal income tax purposes. However, any portion of the increased

yield that is not attributable to a deterioration in the financial condition of the issuer, such as a change in market interest rates, is taken into account.

### **Proposed Effective Date**

The regulations, as proposed, apply to alterations of the terms of a debt instrument on or after the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**. A taxpayer, however, may rely on these amendments for alterations of the terms of a debt instrument occurring before that date.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking 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, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how

they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, September 8, 2010, beginning at 10 a.m. in Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, August 11, 2010. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### **Drafting Information**

The principal author of these regulations is Diana Imholtz, Office of Associate Chief Counsel (Financial Institutions & Products). 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.

## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be 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 amended by revising paragraphs (c)(2)(ii), (e)(5)(i) and (h) and adding paragraph (f)(7) to read as follows:

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

\* \* \* \* \*

(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 under this section, 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 the date of publication of the Treasury decision adopting these rules as final regulation in the **Federal Register**. 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.

[FR Doc. 2010-13492 Filed 06/03/2010 at 8:45 am; Publication Date: 06/04/2010]