

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 ex-

tent 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 pow-

ers 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 deductible 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 re-issued 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