

or preferred stock is exchanged for common stock, or common stock is exchanged for preferred stock, or common stock in one corporation is exchanged for common stock in another corporation. See paragraph (1) of section 1301-1 for certain transactions treated as distributions under section 301. See paragraph (e)(5) of § 1.368-2 for certain transactions which result in deemed distributions under section 305(c) to which sections 305(b)(4) and 301 apply.

(b) For rules relating to recognition of gain or loss where an exchange is not wholly in kind, see subsections (b) and (c) of section 1031. For rules relating to the basis of property acquired in an exchange described in paragraph (a) of this section, see subsection (d) of section 1031.

(c) A transfer is not within the provisions of section 1036(a) if as part of the consideration the other party to the exchange assumes a liability of the taxpayer (or if the property transferred is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of section 1031(b).

(d) *Nonqualified preferred stock.* See § 1.356-7(a) for the applicability of the definition of nonqualified preferred stock in section 351(g)(2) for stock issued prior to June 9, 1997, and for stock issued in transactions occurring after June 8, 1997, that are described in section 1014(f)(2) of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788, 921).

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 7281, 38 FR 18540, July 12, 1973; T.D. 8904, 65 FR 58652, Oct. 2, 2000]

§ 1.1037-1 Certain exchanges of United States obligations.

(a) *Nonrecognition of gain or loss—(1) In general.* Section 1037(a) provides for the nonrecognition of gain or loss on the surrender to the United States of obligations of the United States issued under the Second Liberty Bond Act (31 U.S.C. 774(2)) when such obligations are exchanged solely for other obligations issued under that Act and the Secretary provides by regulations promulgated in connection with the issue of such other obligations that gain or loss is not to be recognized on such exchange. It is not necessary that at the

time of the exchange the obligation which is surrendered to the United States be a capital asset in the hands of the taxpayer. For purposes of section 1037(a) and this subparagraph, a circular of the Treasury Department which offers to exchange obligations of the United States issued under the Second Liberty Bond Act for other obligations issued under that Act shall constitute regulations promulgated by the Secretary in connection with the issue of the obligations offered to be exchanged if such circular contains a declaration by the Secretary that no gain or loss shall be recognized for Federal income tax purposes on the exchange or grants the privilege of continuing to defer the reporting of the income of the bonds exchanged until such time as the bonds received in the exchange are redeemed or disposed of, or have reached final maturity, whichever is earlier. See, for example, regulations of the Bureau of the Public Debt, 31 CFR part 339, or Treasury Department Circular 1066, 26 FR 8647. The application of section 1037(a) and this subparagraph will not be precluded merely because the taxpayer is required to pay money on the exchange. See section 1031 and the regulations thereunder if the taxpayer receives money on the exchange.

(2) *Recognition of gain or loss postponed.* Gain or loss which has been realized but not recognized on the exchange of a U.S. obligation for another such obligation because of the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as related to section 1037(a)) shall be recognized at such time as the obligation received in the exchange is disposed of, or redeemed, in a transaction other than an exchange described in section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) or reaches final maturity, whichever is earlier, to the extent gain or loss is realized on such later transaction.

(3) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase

in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. A, the owner of a \$1,000 series E U.S. savings bond purchased for \$750 and bearing an issue date of May 1, 1945, surrenders the bond to the United States in exchange solely for series H U.S. savings bonds on February 1, 1964, when the series E bond has a redemption value of \$1,304.80. In the exchange A pays an additional \$195.20 and obtains three \$500 series H bonds. None of the \$554.80 gain (\$1,304.80 less \$750) realized by A on the series E bond is recognized at the time of the exchange.

Example 2. In 1963, B purchased for \$97 a marketable U.S. bond which was originally issued at its par value of \$100. In 1964 he surrenders the bond to the United States in exchange solely for another marketable U.S. bond which then has a fair market value of \$95. B's loss of \$2 on the old bond is not recognized at the time of the exchange, and his basis for the new bond is \$97 under section 1031(d). If it has been necessary for B to pay \$1 additional consideration in the exchange, his basis in the new bond would be \$98.

Example 3. The facts are the same as in example (2) except that B also receives \$1 interest on the old bond for the period which has elapsed since the last interest payment date and that B does not pay any additional consideration on the exchange. As in example (2), B has a loss of \$2 which is not recognized at the time of the exchange and his basis in the new bond is \$97. In addition, the \$1 of interest received on the old bond is includible in gross income. B holds the new bond 1 year and sells it in the market for \$99 plus interest. At this time he has a gain of \$2, the difference between his basis of \$97 in the new bond and the sales price of such bond. In addition, the interest received on the new bond is includible in gross income.

Example 4. The facts are the same as in example (2), except that in addition to the new bond B also receives \$1.85 in cash, \$0.85 of which is interest. The \$0.85 interest received is includible in gross income. B's loss of \$1 (\$97 less \$96) on the old bond is not recognized at the time of the exchange by reason of section 1031(c). Under section 1031(d) B's basis in the new bond is \$96 (his basis of \$97 in the old bond, reduced by the \$1 cash received in the exchange).

Example 5. (a) For \$975 D subscribes to a marketable U.S. obligation which has a face value of \$1,000. Thereafter, he surrenders this obligation to the United States in exchange solely for a 10-year marketable \$1,000 obligation which at the time of exchange has a fair

market value of \$930, at which price such obligation is initially offered to the public. At the time of issue of the new obligation there was no intention to call it before maturity. Five years after the exchange D sells the new obligation for \$960.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of \$45 (\$975 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is \$975 (the same basis as that of the old obligation).

(d) On the sale of the new obligation D sustains a loss of \$15 (\$975 less \$960), all of which is recognized by reason of section 1002.

Example 6. (a) The facts are the same as in example (5), except that five years after the exchange D sells the new obligation for \$1,020.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of \$45 (\$975 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is \$975 (the same basis as that of the old obligation). The issue price of the new obligation under section 1232(b)(2) is \$930.

(d) On the sale of the new obligation D realizes a gain of \$45 (\$1,020 less \$975), all of which is recognized by reason of section 1002. Of this gain of \$45, the amount of \$35 is treated as ordinary income and \$10 is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B) on sale of new obligation:	
Stated redemption price of new obligation at maturity	\$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii):	
(\$70×60 months/120 months)	35
(2) Long-term capital gain (\$45 less \$35)	10

Example 7. (a) The facts are the same as in example (5), except that D retains the new obligation and redeems it at maturity for \$1,000.

(b) On the exchange of the old obligation for the new obligation D sustains a loss of \$45 (\$975 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new obligation in D's hands, determined under section 1031(d), is \$975 (the same basis as that of the old obligation). The issue price of the new obligation is \$930 under section 1232(b)(2).

(d) On the redemption of the new obligation D realizes a gain of \$25 (\$1,000 less \$975), all of which is recognized by reason of section 1002. Of this gain of \$25, the entire amount is treated as ordinary income, determined as follows:

Ordinary income under first sentence of section 1232(a)(2)(B) on redemption of new obligation:	
Stated redemption price of new obligation at maturity	\$1,000
Less: Issue price of new obligation under section 1232(b)(2)	930
Original issue discount on new obligation	70
Proration under section 1232(a)(2)(B)(ii): (\$70×120 months/120 months), but such amount not to exceed the \$25 gain recognized on redemption	25

(b) *Application of section 1232 upon disposition or redemption of new obligation—*
 (1) *Exchanges involving nonrecognition of gain on obligations issued at a discount.* If an obligation, the gain on which is subject to the first sentence of section 1232(a)(2)(B), because the obligation was originally issued at a discount, is surrendered to the United States in exchange for another obligation and any part of the gain realized on the exchange is not then recognized because of the provisions of section 1037(a) (or because of so much of section 1031(b) as relates to section 1037(a)), the first sentence of section 1232(a)(2)(B) shall apply to so much of such unrecognized gain as is later recognized upon the disposition or redemption of the obligation which is received in the exchange as though the obligation so disposed of or redeemed were the obligation surrendered, rather than the obligation received, in such exchange. See the first sentence of section 1037(b)(1). Thus, in effect that portion of the gain which is unrecognized on the exchange but is recognized upon the later disposition or redemption of the obligation received from the United States in the exchange shall be considered as ordinary income in an amount which is equal to the gain which, by applying the first sentence of section 1232(a)(2)(B) upon the earlier surrender of the old obligation to the United States, would have been considered as ordinary income if the gain had been recognized upon such earlier exchange. Any portion of the gain which is recognized under section 1031(b) upon the earlier exchange and is treated at such time as ordinary income shall be deducted from the gain which is treated as ordinary income by applying the first sentence of section 1232(a)(2)(B) pursuant to this subparagraph upon the disposition or redemption of the obli-

gation which is received in the earlier exchange. This subparagraph shall apply only in a case where on the exchange of United States obligations there was some gain not recognized by reason of section 1037(a) (or so much of section 1031(b) as relates to section 1037(a)); it shall not apply where, only loss was unrecognized by reason of section 1037(a).

(2) *Rules to apply when a nontransferable obligation is surrendered in the exchange.* For purposes of applying both section 1232(a)(2)(B) and subparagraph (1) of this paragraph to the total gain realized on the obligation which is later disposed of or redeemed, if the obligation surrendered to the United States in the earlier exchange is a nontransferable obligation described in section 454 (a) or (c)—

(i) The aggregate amount considered, with respect to the obligation so surrendered in the earlier exchange, as ordinary income shall not exceed the difference between the issue price of the surrendered obligation and the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, and

(ii) The issue price of the obligation which is received from the United States in the earlier exchange shall be considered to be the stated redemption price of the surrendered obligation which applied at the time of the earlier exchange, increased by the amount of other consideration (if any) paid to the United States as part of the earlier exchange.

If the obligation received in the earlier exchange is a nontransferable obligation described in section 454(c) and such obligation is partially redeemed before final maturity or partially disposed of by being partially reissued to another owner, the amount determined by applying subdivision (i) of this subparagraph shall be determined on a basis proportional to the total denomination of obligations redeemed or disposed of. See paragraph (c) of §1.454-1.

(3) *Long-term capital gain.* If, in a case where both subparagraphs (1) and (2) of this paragraph are applied, the total gain realized on the redemption or disposition of the obligation which is received from the United States in the exchange to which section 1037(a) (or so

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much of section 1031(b) as related to section 1037(a)) applies exceeds the amount of gain which, by applying such subparagraphs, is treated as ordinary income, the gain in excess of such amount shall be treated as long-term capital gain.

(4) *Illustrations.* The application of this paragraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and has never elected under section 454(a) to include in gross income currently the annual increase in the redemption price of non-interest-bearing obligations issued at a discount. In addition, it is assumed that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. (a) A purchased a noninterest-bearing nontransferable U.S. bond for \$74 which was issued after December 31, 1954, and redeemable in 10 years for \$100. Several years later, when the stated redemption value of such bond is \$94.50, A surrenders it to the United States in exchange for \$1 in cash and a 10-year marketable bond having a face value of \$100. On the date of exchange the bond received in the exchange has a fair market value of \$96. Less than one month after the exchange, A sells the new bond for \$96.

(b) On the exchange of the old bond for the new bond A realizes a gain of \$23, determined as follows:

Amount realized (a new bond worth \$96 plus \$1 cash)	\$97
Less: Adjusted basis of old bond	74
Gain realized	23

Pursuant to so much of section 1031(b) as applies to section 1037(a), the amount of such gain which is recognized is \$1 (the money received). Such recognized gain of \$1 is treated as ordinary income. On the exchange of the old bond a gain of \$22 (\$23 less \$1) is not recognized.

(c) The basis of the new bond in A's hands, determined under section 1031(d) is \$74 (the basis of the old bond, decreased by the \$1 received in cash and increased by the \$1 gain recognized on the exchange).

(d) On the sale of the new bond A realizes a gain of \$22 (\$96 less \$74), all of which is recognized by reason of section 1002. Of this gain of \$22, the amount of \$19.50 is treated as ordinary income and \$2.50 is treated as long-term capital gain, determined as follows:

(1) Ordinary income, treating sale of new bond as though a sale of old bond and applying section 1037(b)(1)(A):	
Stated redemption price of old bond	\$94.50

Less: Issue price of old bond	74.00
Aggregate gain under section 1037(b)(1)(A) (not to exceed \$22 not recognized at time of exchange)	20.50
Less: Amount of such gain recognized at time of exchange	1.00
Ordinary income	19.50

(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(1)(B) to sale of new bond:	
Stated redemption price of new bond at maturity	\$100.00
Less: Issue price of new bond under section 1037(b)(1)(B) (\$94.50 plus \$0 additional consideration paid on exchange)	94.50
Original issue discount on new bond	5.50
Proration under section 1232(a)(2)(B)(ii): (\$5.50×0 months/120 months)	0
(3) Total ordinary income (sum of subparagraphs (1) and (2))	19.50
(4) Long-term capital gain (\$22 less \$19.50)	2.50

Example 2. (a) The facts are the same as in example (1), except that, less than one month after the exchange of the old bond, the new bond is sold for \$92.

(b) On the sale of the new bond A realizes a gain of \$18 (\$92 less \$74), all of which is recognized by reason of section 1002. Of this gain, the entire amount of \$18 is treated as ordinary income. This amount is determined as provided in paragraph (d)(1) of example (1) except that the ordinary income of \$19.50 is limited to the \$18 recognized on the sale of the new bond.

Example 3. (a) The facts are the same as in example (1), except that 2 years after the exchange of the old bond A sells the new bond for \$98.

(b) On the sale of the new bond A realizes a gain of \$24 (\$98 less \$74), all of which is recognized by reason of section 1002. Of this gain of \$24, the amount of \$20.60 is treated as ordinary income and \$3.40 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	\$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to \$1.10 (\$5.50×24 months/120 months)	1.10
(3) Total ordinary income (sum of subparagraphs (1) and (2))	20.60
(4) Long-term capital gain (\$24 less \$20.60)	3.40

Example 4. (a) The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for \$100.

(b) On the redemption of the new bond A realizes a gain of \$26 (\$100 less \$74), all of which is recognized by reason of section 1002. Of this gain of \$26, the amount of \$25 is treated as ordinary income and \$1 is treated as long-term capital gain, determined as follows:

(1) Ordinary income applicable to old bond (determined as provided in paragraph (d)(1) of example (1))	\$19.50
(2) Ordinary income applicable to new bond (determined as provided in paragraph (d)(2) of example (1), except that the proration of the original issue discount under section 1232(a)(2)(B)(ii) amounts to \$5.50 (\$5.50×120 months/120 months))	5.50
(3) Total ordinary income (sum of subparagraphs (1) and (2))	25.00
(4) Long-term capital gain (\$26 less \$25)	1.00

Example 5. (a) In 1958 B purchased for \$7,500 a series E United States savings bond having a face value of \$10,000. In 1965 when the stated redemption value of the series E bond is \$9,760, B surrenders it to the United States in exchange solely for a \$10,000 series H U.S. savings bond, after paying \$240 additional consideration. B retains the series H bond and redeems it at maturity in 1975 for \$10,000, after receiving all the semiannual interest payments thereon.

(b) On the exchange of the series E bond for the series H bond, B realizes a gain of \$2,260 (\$9,760 less \$7,500), none of which is recognized at such time by reason of section 1037(a).

(c) The basis of the series H bond in B's hands, determined under section 1031(d), is \$7,740 (the \$7,500 basis of the series E bond, plus \$240 additional consideration paid for the series H bond).

(d) On the redemption of the series H bond, B realizes a gain of \$2,260 (\$10,000 less \$7,740), all of which is recognized by reason of section 1002. This entire gain is treated as ordinary income by treating the redemption of the series H bond as though it were a redemption of the series E bond and by applying section 1037(b)(1)(A).

(e) Under section 1037(b)(1)(B) the issue price of the series H bonds is \$10,000 (\$9,760 stated redemption price of the series E bond at time of exchange, plus \$240 additional consideration paid). Thus, with respect to the series H bond, there is no original issue discount to which section 1232(a)(2)(B) might apply.

Example 6. (a) The facts are the same as in example (5), except that in 1970 B submits the \$10,000 series H bond to the United States for partial redemption in the amount of \$3,000 and for reissuance of the remainder in \$1,000 series H savings bonds registered in his name. On this transaction B receives \$3,000 cash and seven \$1,000 series H bonds, bearing

the original issue date of the \$10,000 bond which is partially redeemed. The \$1,000, series H bonds are redeemed at maturity in 1975 for \$7,000.

(b) On the partial redemption of the \$10,000 series H bond in 1970 B realizes a gain of \$678 (\$3,000 less \$2,322 [\$7,740×\$3,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income, by treating the partial redemption of the series H bond as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the seven \$1,000 series H bonds B realizes a gain of \$1,582 (\$7,000 less \$5,418 [\$7,740×\$7,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

Example 7. (a) The facts are the same as in example (5), except that in 1970 B requests the United States to reissue the \$10,000 series H bond by issuing two \$5,000 series H bonds bearing the original issue date of such \$10,000 bond. One of such \$5,000 bonds is registered in B's name, and the other is registered in the name of C, who is B's son. Each \$5,000 series H bond is redeemed at maturity in 1975 for \$5,000.

(b) On the issuing in 1970 of the \$5,000 series H bond to C, B realizes a gain of \$1,130 (\$5,000 less \$3,870 [\$7,740×\$5,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income by treating the transaction as though it were a redemption of the relevant denominational portion of the series E bond and by applying section 1037(b)(1)(A).

(c) On the redemption at maturity in 1975 of the \$5,000 series H bond registered in his name B realizes a gain of \$1,130 (\$5,000 less \$3,870 [\$7,740×\$5,000/\$10,000]), all of which is recognized at such time by reason of section 1002 and paragraph (c) of § 1.454-1. This entire gain is treated as ordinary income, determined in the manner described in paragraph (b) of this example.

(d) On the redemption at maturity in 1975 of the \$5,000 series H bond registered in his name C does not realize any gain, since the amount realized on redemption does not exceed his basis in the property, determined as provided in section 1015.

(5) *Exchanges involving nonrecognition of gain or loss on transferable obligations issued at not less than par—(i) In general.* If a transferable obligation of the United States which was originally issued at not less than par is surrendered to the United States for another

transferable obligation in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply, the issue price of the obligation received from the United States in the exchange shall be considered for purposes of applying section 1232 to gain realized on the disposition or redemption of the obligation so received, to be the same as the issue price of the obligation which is surrendered to the United States in the exchange, increased by the amount of other consideration, if any, paid to the United States as part of the exchange. This subparagraph shall apply irrespective of whether there is gain or loss unrecognized on the exchange and irrespective of the fair market value, at the time of the exchange, of either the obligation surrendered to, or the obligation received from, the United States in the exchange.

(ii) *Illustrations.* The application of this subparagraph may be illustrated by the following examples, in which it is assumed that the taxpayer uses the cash receipts and disbursements method of accounting and that the old obligations exchanged are capital assets transferred in an exchange in respect of which regulations are promulgated pursuant to section 1037(a):

Example 1. (a) A purchases in the market for \$85 a marketable U.S. bond which was originally issued at its par value of \$100. Three months later, A surrenders this bond to the United States in exchange solely for another \$100 marketable U.S. bond which then has a fair market value of \$88. He holds the new bond for 5 months and then sells it on the market for \$92.

(b) On the exchange of the old bond for the new bond A realizes a gain of \$3 (\$88 less \$85), none of which is recognized by reason of section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is \$85 (the same as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be \$100 (the same issue price as that of the old bond).

(d) On the sale of the new bond A realizes a gain of \$7 (\$92 less \$85), all of which is recognized by reason of section 1002. Of this gain of \$7, the entire amount is treated as long-term capital gain, determined as follows:

(1) Ordinary income under first sentence of section 1232(a)(2)(B), applicable to old bond:		
Stated redemption price of old bond at maturity	\$100	
Less: Issue price of old bond	100	
		0
Original issue discount on old bond		0
(2) Ordinary income under first sentence of section 1232(a)(2)(B), applying section 1037(b)(2) to sale of new bond:		
Stated redemption price of new bond at maturity	100	
Less: Issue price of new bond under section 1037(b)(2)	100	
		0
Original issue discount on new bond		0
(3) Long-term capital gain (\$7 less sum of subparagraphs (1) and (2))		\$7

Example 2. The facts are the same as in example (1), except that A retains the new bond and redeems it at maturity for \$100. On the redemption of the new bond, A realizes a gain of \$15 (\$100 less \$85), all of which is recognized under section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

Example 3. (a) For \$1,000 B subscribes to a marketable U.S. bond which has a face value of \$1,000. Thereafter, he surrenders this bond to the United States in exchange solely for a 10-year marketable \$1,000 bond which at the time of exchange has a fair market value of \$930, at which price such bond is initially offered to the public. Five years after the exchange, B sells the new bond for \$950.

(b) On the exchange of the old bond for the new bond, B sustains a loss of \$70 (\$1,000 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in A's hands, determined under section 1031(d), is \$1,000 (the same basis as that of the old bond).

(d) On the sale of the new bond B sustains a loss of \$50 (\$1,000 less \$950), all of which is recognized by reason of section 1002.

Example 4. (a) The facts are the same as in example (3), except that 5 years after the exchange B sells the new bond for \$1,020.

(b) On the exchange of the old bond for the new bond B sustains a loss of \$70 (\$1,000 less \$930), none of which is recognized pursuant to section 1037(a).

(c) The basis of the new bond in B's hands, determined under section 1031(d), is \$1,000 (the same basis as that of the old bond). The issue price of the new bond for purposes of section 1232(a)(2)(B) is considered under section 1037(b)(2) to be \$1,000 (the same issue price as that of the old bond).

(d) On the sale of the new bond B realizes a gain of \$20 (\$1,020 less \$1,000), all of which is recognized by reason of section 1002. This entire gain is treated as long-term capital gain, determined in the same manner as provided in paragraph (d) of example (1).

(6) *Other rules for applying section 1232.* To the extent not specifically affected by the provisions of section 1037(b) and subparagraphs (1) through (5) of this paragraph, any gain realized on the disposition or redemption of any obligation received from the United States in an exchange to which section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) applies shall be treated in the manner provided by section 1232 if the facts and circumstances relating to the acquisition and disposition or redemption of such obligation require the application of section 1232.

(c) *Holding period of obligation received in the exchange.* The holding period of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall include the period for which the obligation which was surrendered to the United States in the exchange was held by the taxpayer, but only if the obligation so surrendered was at the time of the exchange a capital asset in the hands of the taxpayer. See section 1223 and the regulations thereunder.

(d) *Basis.* The basis of an obligation received from the United States in an exchange to which the provisions of section 1037(a) (or so much of section 1031 (b) or (c) as relates to section 1037(a)) apply shall be determined as provided in section 1031(d) and the regulations thereunder.

(e) *Effective date.* Section 1.1037 and this section shall apply only for taxable years ending after September 22, 1959.

[T.D. 6935, 32 FR 15824, Nov. 17, 1967, as amended by T.D. 7154, 36 FR 24998, Dec. 28, 1971]

§ 1.1038-1 Recquisitions of real property in satisfaction of indebtedness.

(a) *Scope of section 1038—(1) General rule on gain or loss.* If a sale of real property gives rise to indebtedness to the seller which is secured by the real property which is sold, and the seller of such property reacquires such property in a taxable year beginning after September 2, 1964, in partial or full satisfaction of such indebtedness, then, except as provided in paragraphs (b) and

(f) of this section, no gain or loss shall result to the seller from such reacquisition. The treatment so provided is mandatory; however, see §1.1038-3 for an election to apply the provisions of this section to certain taxable years beginning after December 31, 1957. It is immaterial, for purposes of applying this subparagraph, whether the seller realized a gain or sustained a loss on the sale of the real property, or whether it can be ascertained at the time of the sale whether gain or loss occurs as a result of the sale. It is also immaterial what method of accounting the seller used in reporting gain or loss from the sale of the real property or whether at the time of reacquisition such property has depreciated or appreciated in value since the time of the original sale. Moreover, the character of the gain realized on the original sale of the property is immaterial for purposes of applying this subparagraph. The provisions of this section shall apply, except as provided in §1.1038-2, to the reacquisition of real property which was used by the seller as his principal residence and with respect to the sale of which an election under section 121 is in effect or with respect to the sale of which gain was not recognized under section 1034.

(2) *Sales giving rise to indebtedness—(i) Sale defined.* For purposes of this section, it is not necessary for title to the property to have passed to the purchaser in order to have a sale. Ordinarily, a sale of property has occurred in a transaction in which title to the property has not passed to the purchaser, if the purchaser has a contractual right to retain possession of the property so long as he performs his obligations under the contract and to obtain title to the property upon the completion of the contract. However, a sale may have occurred even if the purchaser does not have the right to possession until he partially or fully satisfies the terms of the contract. For example, if S contracts to sell real property to P, and if S promises to convey title to P upon the completion of all of the payments due under the contract and to allow P to obtain possession of the property after 10 percent of the purchase price has been paid, there has been a sale on the date of the contract