

the assumption does not result in a significant alteration.

(iv) The change in the interest rate, if tested under the rules of paragraph (e)(2) of this section, 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 paragraph (e)(4)(i)(C) of this section and is a significant modification under paragraph (e)(4)(i)(A) of this section.

*Example 6. Assumption of mortgage.* (i) A recourse debt instrument is secured by a building. In connection with the sale of the building, the purchaser of the building assumes the debt and is substituted as the new obligor on the debt instrument. The purchaser does not acquire substantially all of the assets of the original obligor.

(ii) The transaction does not satisfy any of the exceptions set forth in paragraph (e)(4)(i)(B) or (C) of this section. Thus, the substitution of the purchaser as the obligor is a significant modification under paragraph (e)(4)(i)(A) of this section.

(iii) Section 1274(c)(4), however, provides that if a debt instrument is assumed in connection with the sale or exchange of property, the assumption is not taken into account in determining if section 1274 applies to the debt instrument unless the terms and conditions of the debt instrument are modified in connection with the sale or exchange. Because the purchaser assumed the debt instrument in connection with the sale of property and the debt instrument was not otherwise modified, the debt instrument is not retested to determine whether it provides for adequate stated interest.

*Example 7. Substitution of a new obligor in section 381(a) transaction.* (i) The interest rate on a 30-year debt instrument issued by a corporation provides for a variable rate of interest that is reset annually on June 1st based on an objective index.

(ii) In the tenth year, the issuer merges (in a transaction to which section 381(a) applies) into another corporation that becomes the new obligor on the debt instrument. The merger occurs on June 1st, at which time the interest rate is also reset by operation of the terms of the instrument. The new interest rate varies from the previous interest rate by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument. The substitution of a new obligor does not result in a change in payment expectations.

(iii) The substitution of the new obligor occurs in a section 381(a) transaction and does not result in a change in payment expectations. Although the interest rate changed by more than the greater of 25 basis points and 5 percent of the annual yield of the unmodified instrument, this alteration did not occur as a result of the transaction and is not a

significant alteration under paragraph (e)(4)(i)(E) of this section. Thus, the substitution meets the requirements of paragraph (e)(4)(i)(B) of this section and is not a significant modification.

*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 and rating agencies lower its credit rating. The issuer and holder agree that the issuer will substitute a letter of credit from another bank with a higher credit rating.

(ii) Under paragraph (e)(4)(iv)(A) of this section, 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 bank with a higher credit rating 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).

*Example 9. Improvement to collateral securing nonrecourse debt.* A parcel of land and its improvements, a shopping center, secure a nonrecourse debt instrument. The obligor expands the shopping center with the construction of an additional building on the same parcel of land. After the construction, the improvements that secure the nonrecourse debt include the new building. The building is an improvement to the property securing the nonrecourse debt instrument and its inclusion in the collateral securing the debt is not a significant modification under paragraph (e)(4)(iv)(B) of this section.

(h) *Effective date.* 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.

[T.D. 8675, 61 FR 32930, June 26, 1996; 61 FR 47822, Sept. 11, 1996]

#### § 1.1001-4 Modifications of certain notional principal contracts.

(a) *Dealer assignments.* For purposes of § 1.1001-1(a), the substitution of a

new party on an interest rate or commodity swap, or other notional principal contract (as defined in §1.446-3(c)(1)), is not treated as a deemed exchange by the nonassigning party of the original contract for a modified contract that differs materially either in kind or in extent if—

(1) The party assigning its rights and obligations under the contract and the party to which the rights and obligations are assigned are both dealers in notional principal contracts, as defined in §1.446-3(c)(4)(iii); and

(2) The terms of the contract permit the substitution.

(b) *Effective date.* This section applies to assignments of interest rate swaps, commodity swaps, and other notional principal contracts occurring on or after September 23, 1996.

[T.D. 8763, 63 FR 4396, Jan. 29, 1998]

**§1.1001-5 European Monetary Union (conversion to the euro).**

(a) *Conversion of currencies.* For purposes of §1.1001-1(a), the conversion to the euro of legacy currencies (as defined in §1.985-8(a)(1)) is not the exchange of property for other property differing materially in kind or extent.

(b) *Effect of currency conversion on other rights and obligations.* For purposes of §1.1001-1(a), if, solely as the result of the conversion of legacy currencies to the euro, rights or obligations denominated in a legacy currency become rights or obligations denominated in the euro, that event is not the exchange of property for other property differing materially in kind or extent. Thus, for example, when a debt instrument that requires payments of amounts denominated in a legacy currency becomes a debt instrument requiring payments of euros, that alteration is not a modification within the meaning of §1.1001-3(c).

(c) *Effective date.* This section applies to tax years ending after July 29, 1998.

[T.D. 8927, 66 FR 2218, Jan. 11, 2001]

**§ 1.1002-1 Sales or exchanges.**

(a) *General rule.* The general rule with respect to gain or loss realized upon the sale or exchange of property as determined under section 1001 is that the entire amount of such gain or loss is

recognized except in cases where specific provisions of subtitle A of the code provide otherwise.

(b) *Strict construction of exceptions from general rule.* The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a necessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

(c) *Certain exceptions to general rule.* Exceptions to the general rule are made, for example, by sections 351(a), 354, 361(a), 371(a)(1), 371(b)(1), 721, 1031, 1035 and 1036. These sections describe certain specific exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated.

(d) *Exchange.* Ordinarily, to constitute an exchange, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only.