Notice of Proposed Rulemaking; Notice of Public Hearing; and Withdrawal of Previous Proposed Regulations Section

Guidance Regarding the Treatment of Certain Contingent Payment Debt Instruments With One or More Payments That Are Denominated in, or Determined by Reference to, a Nonfunctional Currency

REG–106486–98; INTL–0015–91

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of public hearing; and withdrawal of previous proposed regulations section.

SUMMARY: This document contains proposed regulations regarding the treatment of contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a currency other than the taxpayer's functional currency. These regulations are necessary because current regulations do not provide guidance concerning the tax treatment of such instruments. The proposed regulations generally provide that taxpayers should apply the existing rules under section 1275 of the Internal Revenue Code, with certain modifications, to nonfunctional currency contingent payment debt instruments. This document also withdraws existing proposed regulations and provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for December 3, 2003, at 10 a.m. must be submitted by November 12, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–106486–98), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 4 p.m. to: REG–106486–98, Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Milton Cahn at (202) 622–3870; concerning submission and delivery of comments and the public hearing, Treena Garrett, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

PAPERWORK REDUCTION ACT

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of Information should be received by October 28, 2003. Comments are specifically requested concerning:

Whether the proposed collections of information is necessary for the proper performance of the functions of the **Internal Revenue Service**, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collections of information in this proposed regulation are in §1.988–6(a)(1) (cross reference to §1.1275–4) and §1.988–6(d)(3). This information is required to ensure consistency in the treatment of the debt instrument between the issuer and the holders. This information will be used for audit and examination purposes. The disclosure of information is mandatory as regards the issuers of nonfunctional currency contingent payment debt instruments. The reporting of information is mandatory as regards holders of debt instruments which determine their own projected payment schedule. The recordkeeping requirement is mandatory for any party that determines the comparable yield and projected payment schedule for a debt instrument. The likely respondents are business or other for-profit institutions.

Taxpayers provide the information on a statement attached to its timely filed federal income tax return for the taxable year that includes the acquisition date of the debt instrument.

Estimated total annual reporting, and/or recordkeeping burden: 100 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: 1 hour.

Estimated number of respondents and/or recordkeepers: 100

Estimated annual frequency of responses: on occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return

information are confidential, as required by 26 U.S.C. 6103.

Background

On March 17, 1992, Treasury and the IRS issued proposed regulations (INTL–0015–91), §§1.988–1(a)(3), (4) and (5), regarding contingent payment debt instruments, dual currency debt instruments and multi-currency debt instruments. The proposed regulations followed the general approach in the then-proposed §1.1275–4(g) contingent payment debt regulations (LR–189–84, 1986–1 C.B. 820 [51 FR 12022] (1986), amended at 56 FR 8308 (1991)) and bifurcated such debt instruments into contingent and noncontingent components. After an instrument was bifurcated, the proposed regulations applied the rules in §§1.988–1 through 1.988–5, as appropriate, to the resulting components.

On December 16, 1994, Treasury and the IRS withdrew the then proposed §1.1275–4(g) regulations and proposed a new set of §1.1275–4 regulations (FI–59–91, 1995–1 C.B. 895 [59 FR–64884]). These regulations were finalized on June 14, 1996.

Section 1.1275–4 of the final regulations adopted the "noncontingent bond method" for certain contingent payment debt instruments. Under the noncontingent bond method, interest accrues on a contingent payment debt instrument at a rate equal to the instrument's comparable yield, which is the yield at which an issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. In addition, the noncontingent bond method treats all interest on a debt instrument as original issue discount, which must be taken into account as it accrues, regardless of the taxpayer's normal method of accounting.

Under the noncontingent bond method, the comparable yield is used to construct a projected payment schedule for the debt instrument, which includes a projected amount for each contingent payment. If the actual amount of a contingent payment is greater than the projected amount, the difference is treated as additional interest. If the actual amount of a contingent payment is less than the projected amount, the difference generally offsets current interest accruals. In some cases, the difference may result in a loss to the holder and income to the issuer.

On August 2, 1999, as a result of the withdrawal of the 1994 proposed §1.1275–4(g) regulations and the promulgation of the final §1.1275–4 regulations, the IRS issued Announcement 99–76, 1999–2 C.B. 223, which provided a description of a regulatory approach that Treasury and the IRS were considering as a replacement to the proposed regulations in §§1.988–1(a)(3), (4) and (5) for contingent payment debt instruments with one or more payments denominated in, or determined by reference to, a nonfunctional currency. Announcement 99–76 stated that Treasury and the IRS were considering issuing regulations that would apply the noncontingent bond method in the taxpayer's nonfunctional currency and would translate payments received on the instrument into functional currency under the rules of §§1.988–1 through 1.988–5. Announcement 99–76 requested comments on this approach. No comments were received.

Treasury and the IRS believe that proposed regulations §1.988–1(a)(3), (4) and (5) should be withdrawn because they incorporate the bifurcation approach rather than the noncontingent bond method ultimately adopted under §1.1275–4. Treasury and the IRS believe, as reflected in Announcement 99–76, that nonfunctional currency contingent payment debt instruments should be accounted for under rules similar to those that govern the treatment of functional currency contingent payment debt instruments. Treasury and the IRS believe that providing a consistent set of rules in this area is in the best interests of sound tax administration.

Explanation of Provisions

In General

These proposed regulations provide guidance for four different types of debt instruments: (1) debt instruments issued for money or publicly-traded property for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which have one or more non-currency contingencies, (2) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which have no non-currency contingencies, (3) debt instruments issued for money or publicly-traded property for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which also have one or more non-currency contingencies, and (4) debt instruments which otherwise would fall into one of the three foregoing categories but for the fact that the instruments are not issued for money or publicly-traded property. These proposed regulations do not discuss the treatment of tax-exempt obligations described in §1.1275–4(d) which are denominated in one or more nonfunctional currencies. Comments are requested as to the proper treatment of such instruments.

Consistent with the approach described in Announcement 99–76, these proposed regulations generally apply the rules of §1.1275–4(b) (*i.e.*, the noncontingent bond method) to nonfunctional currency contingent payment debt instruments issued for money or publicly traded property. The proposed regulations generally provide that the noncontingent bond method is applied in the currency in which the instrument is denominated (the denomination currency).

Application of the §1.1275–4(b) rules to nonfunctional currency contingent instruments generally requires taxpayers (i) to accrue interest in the denomination currency at a yield at which the issuer would issue a fixed rate debt instrument denominated in the denomination currency with terms and conditions similar to those of the contingent payment debt instrument, (ii) to translate the interest accrued from the denomination currency into the functional currency (and account for foreign currency gain or loss on payments of interest and principal) under the principles of §1.988–2(b), and (iii) to account for gain or loss arising from contingencies in a manner consistent with the rules of §1.1275–4(b).

Applying the Noncontingent Bond Method in the Denomination Currency

As noted, the proposed regulations require taxpayers to apply the noncontingent bond method in the instrument's denomination currency. For example, in the case of an instrument whose denomination currency is the British pound, an issuer whose functional currency is the U.S. dollar would first determine the comparable yield of the instrument, that is, the yield at which the issuer would issue a fixed rate instrument in British pounds with terms and conditions similar to those of the instrument actually being issued. Second, the issuer would construct a projected payment schedule applying that yield. Third, the amount of interest accrued in each taxable year would be determined in British pounds based on the comparable yield and translated into dollars under the principles of section 988. Fourth, the issuer and holder would account for differences between the projected amount of payments and the actual amount of payments (so-called positive adjustments and negative adjustments) under rules similar to those in §1.1275–4(b). Consistent with the rules of §1.1275–4(b), the proposed regulations provide that net positive adjustments are treated as additional interest on the instrument. Net negative adjustments generally offset current interest accruals, and in some cases may result in a loss to the holder and income to the issuer. Finally, the issuer and holders would determine foreign currency gain or loss with respect to interest and principal payments on the instrument.

Determination of the comparable yield and projected payment schedule

Consistent with §1.1275–4(b)(4)(iv), the holder uses the yield and projected payment schedule determined by the issuer to determine the holder's interest accruals and adjustments for a debt instrument. If the issuer does not determine a comparable yield and projected payment schedule for the debt instrument, or if the issuer's comparable yield or projected payment schedule is unreasonable, the holder of the debt instrument must determine the comparable yield and the projected payment schedule for the debt instrument under the rules of the proposed regulations. A holder that determines its own comparable yield and projected payment schedule must explicitly disclose, in the manner set forth in §1.1275–4(b)(4)(iv), both this fact and the reason why the holder made its own determination.

Determination of Basis

In general, the proposed regulations provide that a holder maintains its adjusted basis in functional currency by computing basis adjustments in the denomination currency under the rules of §1.1275–4(b)(7)(iii) and then translating such adjustments into functional currency. Thus, the proposed regulations provide that a holder's basis is increased by the holder's accrued but unpaid interest inclusions on the debt instrument, generally without regard to any positive or negative adjustments, and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. These amounts are translated into functional currency under the principles of §1.988–2(b).

Determination of Amount Realized

The proposed regulations generally follow §1.1275–4(b)(7)(iv) in determining the amount realized, but do so in the denomination currency. Thus, for purposes of determining the amount realized by a holder on the scheduled retirement of a debt instrument, the holder generally is treated as receiving the projected amount of any contingent payment due at maturity. In the case of a sale, exchange or unscheduled retirement of a debt instrument, general recognition principles of tax law generally apply (*e.g.,* section 1001(b)). However, the amount realized by a holder on either the scheduled retirement, or the sale, exchange, or unscheduled retirement of a debt instrument, is reduced by any negative adjustment carryforward existing in the taxable year of the sale, exchange or retirement.

To calculate gain or loss other than foreign currency gain or loss, the proposed regulations require the translation of the amount realized into functional currency. Foreign currency gain or loss is computed separately, as described below. The proposed regulations generally translate the amount realized by reference to the rates used to translate the components of interest and principal that make up adjusted basis. The amount realized is translated using the adjusted basis rates in order to separate from the foreign currency gain or loss the amount of gain or loss on the sale, exchange or retirement of the debt instrument which does not result from changes in foreign exchange rates. Thus, where the amount realized in the denomination currency equals the adjusted basis of the instrument in the denomination currency prior to translation, the amount realized is translated in its entirety by reference to the rates used to translate adjusted basis. Where the amount realized differs from the adjusted basis prior to translation, additional attribution and translation rules are required.

Where the amount realized in the denomination currency is less than the adjusted basis in the denomination currency, that is, where the holder realizes a loss (not taking into account foreign currency gain or loss), the following rules apply as to which parts of adjusted basis are not recovered. In the case of a scheduled retirement at maturity, the loss is attributable to principal (the amount in denomination currency which the holder paid to purchase the debt instrument). The loss is attributable to principal because the holder will not entirely recover the holder's original investment in the debt instrument. In the case of a sale or exchange, the loss is first attributable to accrued interest. Attributing the loss first to interest results in symmetrical treatment between a loss resulting from a negative adjustment and a loss resulting from a sale.

When the holder's amount realized in the denomination currency exceeds the amount of its basis in the denomination currency prior to translation, that is, where the holder realizes a gain (not taking into account foreign currency gain or loss), the excess of amount realized over adjusted basis is translated at the spot rate on the date of receipt. This rule ensures symmetrical treatment between a positive adjustment and a gain on the instrument.

Determination of Foreign Currency Gain or Loss

The proposed regulations provide that foreign currency gain or loss is determined

on an instrument with respect to principal and interest based on the comparable yield and projected payment schedule under the principles of §1.988–2(b). In general, no foreign currency gain or loss is recognized until payment is made or received pursuant to the instrument, and no foreign currency gain or loss is computed with respect to positive or negative adjustments. However, foreign currency gain or loss is determined with respect to positive adjustments described in §1.1275–4(b)(9)(ii) (relating to certain fixed but deferred contingent payments), based upon the difference between the spot rate on the date the positive adjustment becomes fixed and the spot rate on the date the positive adjustment is paid or received.

Source Rules

Consistent with the rules of §1.1275–4(b)(6)(ii), the proposed regulations provide that all gain (other than foreign currency gain) on an instrument is characterized as interest for all tax purposes, including source and character rules. Losses of a holder from a contingent payment debt instrument are generally sourced by reference to the rules of §1.1275–4(b)(9)(iv). Under §1.1275–4(b)(9)(iv), a holder's deductions or loss related to a contingent payment debt instrument that are treated as ordinary losses are treated as deductions that are definitely related to the class of gross income to which income from such debt instrument belongs. Deductions or losses that the holder treats as capital losses are allocated, consistently with the general principles of §1.865–1(b)(2), to the class of gross income with respect to which interest income from the instrument would give rise.

Treatment of Subsequent Holders

The proposed regulations provide that the rules of §1.1275–4(b)(9) generally apply to subsequent holders of an instrument who purchase the instrument for an amount greater or less than the instrument's adjusted issue price (determined in the denomination currency). Accordingly, to the extent that the purchase price for an instrument exceeds the adjusted issue price of the instrument, the holder is required to allocate such excess to interest accrued on the instrument or to projected payments on the instrument in a reasonable manner. Each such allocation is treated as a negative adjustment on the instrument, and the holder's basis on the instrument is decreased as these negative adjustments are taken into account.

To the extent that the adjusted issue price of the instrument exceeds its purchase price, the holder is required to allocate such excess to interest accrued on the instrument or to projected payments on the instrument in a reasonable manner. As the difference is taken into account, the holder is treated as receiving a positive adjustment on the instrument, and the holder's basis is increased as these positive adjustments are taken into account.

The proposed regulations generally translate the difference between the purchase price and adjusted issue price into functional currency at the rate used to translate the interest or projected payment subject to the adjustment. Thus, for example, a positive adjustment attributable to interest is translated at the same rate used to translate interest in the period in which it accrues (*e.g.*, the average rate for the accrual period). The basis adjustment corresponding to such a positive or negative adjustment is translated at the same rate applicable to the positive or negative adjustment itself.

Netting

The proposed regulations do not provide for the netting of market gain or loss with currency gain or loss on nonfunctional currency contingent payment debt instruments. On the one hand, different character and source rules generally apply to market gain or loss and currency gain or loss, and netting such items may produce results inconsistent with the tax treatment of other types of instruments. On the other hand, where market gain or loss and currency gain or loss counteract each other with respect to a taxpayer, requiring separate recognition of such gain and loss may not accurately reflect the economic benefits and burdens associated with the instrument. Accordingly, Treasury and the IRS request comments regarding the extent to which netting should be permitted or required. *Examples 2* and *4* of the proposed regulations demonstrate cases in which netting potentially could be permitted or required because both illustrate instances in which market loss could be netted against currency gain.

Debt Instruments Denominated in Multiple Currencies

In the case of an instrument for which payments are denominated in, or determined by reference to, more than one currency, the proposed regulations provide that the issuer must first determine the instrument's predominant currency, which will be used as the instrument's denomination currency for purposes of applying the rules of the proposed regulations. The predominant currency of the instrument is determined on the issue date by comparing the present value in functional currency of the noncontingent and projected payments denominated in, or determined by reference to, each currency. For this purpose, the applicable discount rate must be a nonfunctional currency discount rate, but the rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance.

After the denomination currency has been determined, all payments on the instrument that are denominated in, or determined by reference to, a currency other than the denomination currency are treated as non-currency related contingent payments for purposes of applying the rules of the proposed regulations. Treasury and the IRS request comments regarding whether all gain or loss with respect to a debt instrument for which payments are denominated in, or determined by reference to, more than one currency and which has no non-currency contingencies should be treated as foreign currency gain or loss.

Debt Instruments Issued for Non-publicly Traded Property

In the case of a nonfunctional currency contingent debt instrument issued for nonpublicly traded property, the instrument is not accounted for using the noncontingent bond method. Rather, the debt instrument is separated into its components based on

the currency in which the payments are denominated and whether the payments are contingent or noncontingent. The noncontingent components in each currency are treated as a separate debt instrument denominated in the currency in which the payment (or payments) is denominated. A component consisting of a contingent payment is generally treated in the manner provided in §1.1275–4(c)(4). For purposes of the contingent payment, the test rate (the interest rate which is used to discount the contingent payment so as to determine the amount of the payment which is treated as principal, and the amount which is treated as interest) is determined by reference to the dollar unless the dollar does not reasonably reflect the economic substance of the contingent component.

Proposed Effective Dates

Section 1.988–6 is proposed to apply to nonfunctional currency contingent payment debt instruments issued 60 days or more after the date §1.988–6 is published as a final regulation in the **Federal Register**.

Special Analysis

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 is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few, if any, small entities issue or hold foreign currency denominated contingent payment debt instruments. Generally, it is expected that the only domestic holders of these instruments will likely be financial institutions, investment banking firms, investment funds, and other sophisticated investors, due to the foreign currency risk and other contingencies inherent in these instruments. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be 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 (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed regulations 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 December 3, 2003, at 10 a.m. in room 6718, 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 November 12, 2003. 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 Milton Cahn of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Section 1.988–1(a)(3), (4) and (5) as proposed on March 17, 1992 at 57 FR 9218 income tax regulations are withdrawn, and 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 1.988–2 is amended by:

1. Adding the text of paragraph (b)(2)(i)(B)(*1*).

2. Removing the last sentence of paragraph (b)(2)(i)(B)(*2*).

The addition reads as follows:

§1.988–2 Recognition and computation of exchange gain or loss.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(B) * * * (*1*) *Operative rules*. See §1.988–6 for rules applicable to contingent debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

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Par. 3. Section 1.988–6 is added to read as follows:

§1.988–6 Nonfunctional currency contingent payment debt instruments.

(a) *In general*—(1) *Scope*. This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment debt instruments described in this paragraph (a)(1). Except as set forth by the rule in this section, the rules in §1.1275–4 (relating to contingent payment debt instruments) apply to the following instruments—

(i) A debt instrument described in §1.1275–4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and

(iv) A debt instrument otherwise described in paragraph (a)(1)(i), (ii) or (iii) of this section, except that the debt instrument is described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1) (*e.g.*, the instrument is issued for non-publicly traded property).

(2) *Exception for hyperinflationary currencies*—(i) *In general*. Except as provided in paragraph (a)(2)(ii) of this section, this section shall not apply to an instrument described in paragraph (a)(1) of this section if any payment made under such instrument is determined by reference to a hyperinflationary currency, as defined in §1.985–1(b)(2)(ii)(D). In such case, the amount, timing, source and character of interest, principal, foreign currency gain or loss, and gain or loss relating to a non-currency contingency shall be determined under the method that reflects the instrument's economic substance.

(ii) *Discretion as to method*. If a taxpayer does not account for an instrument described in paragraph (a)(2)(i) of this section in a manner that reflects the instrument's economic substance, the Commissioner may apply the rules of this section to such an instrument or apply the principles of §1.988–2(b)(15), reasonably taking into account the contingent feature or features of the instrument.

(b) *Instruments described in paragraph (a)(1)(i) of this section*—(1) *In general*. Paragraph (b)(2) of this section provides rules for applying the noncontingent bond method (as set forth in §1.1275–4(b)) in the nonfunctional currency in which a debt instrument described in paragraph (a)(1)(i) of this section is denominated, or by reference to which its payments are determined (the denomination currency). Paragraph (b)(3) of this section describes how amounts determined in paragraph (b)(2) of this section shall be translated from the denomination currency of the instrument into the taxpayer's functional currency. Paragraph (b)(4) of this section describes how gain or loss (other than foreign currency gain or loss) shall be determined and characterized with respect to the instrument. Paragraph (b)(5) of this section describes how foreign currency gain or loss shall be determined with respect to accrued interest and principal on the instrument. Paragraph (b)(6) of this section provides rules for determining the source and character of any gain or loss with respect to the instrument. Paragraph (b)(7) of this section provides rules for subsequent holders of an instrument who purchase the instrument for an amount other than the adjusted issue price of the instrument. Paragraph (c) of this section provides examples of the application of paragraph (b) of this section. See paragraph (d) of this section for the determination of the denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section. See paragraph (e) of this section for the treatment of an instrument described in paragraph (a)(1)(iv) of this section.

(2) *Application of noncontingent bond method*—(i) *Accrued interest*. Interest accruals on an instrument described in paragraph (a)(1)(i) of this section are initially determined in the denomination currency of the instrument by applying the noncontingent bond method, set forth in §1.1275–4(b), to the instrument in its denomination currency. Accordingly, the comparable yield, projected payment schedule, and comparable fixed rate debt instrument, described in §1.1275–4(b)(4), are determined in the denomination currency. For purposes of applying the noncontingent bond method to instruments described in this paragraph, the applicable Federal rate described in §1.1275–4(b)(4)(i) shall be the rate described in §1.1274–4(d) with respect to the denomination currency.

(ii) *Net positive and negative adjustments*. Positive and negative adjustments, and net positive and net negative adjustments, with respect to an instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(6) (and §1.1275–4(b)(9)(i) and (ii), if applicable) in the denomination currency. Accordingly, a net positive adjustment is treated as additional interest (in the denomination currency) on the instrument. A net negative adjustment first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the denomination currency. If a net negative adjustment exceeds the interest that would otherwise be accrued by the taxpayer during the current tax year in the denomination currency, the excess is treated as ordinary loss (if the taxpayer is a holder of the instrument) or ordinary income (if the taxpayer is the issuer of the instrument). The amount treated as ordinary loss by a holder with respect to a net negative adjustment is limited, however, to the amount by which the holder's total interest inclusions on the debt instrument (determined in the denomination currency) exceed the total amount of the holder's net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in the denomination currency). Similarly, the amount treated as ordinary income by an issuer with respect to a net negative adjustment is limited to the amount by which the issuer's total interest deductions on the debt instrument (determined in the denomination currency) exceed the total amount of the issuer's net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in the denomination currency). To the extent a net negative adjustment exceeds the current year's interest accrual and the amount treated as ordinary loss to a holder (or ordinary income to the issuer), the excess is treated as a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C), in the denomination currency.

(iii) *Adjusted issue price*. The adjusted issue price of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. Accordingly, the adjusted issue price is equal to the debt instrument's issue price in the denomination currency, increased by the interest previously accrued on the debt instrument (determined without regard to any net positive or net negative adjustments on the instrument) and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument. All adjustments to the adjusted issue price are calculated in the denomination currency.

(iv) *Adjusted basis*. The adjusted basis of an instrument described in paragraph (a)(1)(i) of this section is determined by applying the rules of §1.1275–4(b)(7) in the taxpayer's functional currency. In accordance with those rules, a holder's basis in the debt instrument is increased

by the interest previously accrued on the debt instrument (translated into functional currency), without regard to any net positive or net negative adjustments on the instrument (except as provided in paragraph (b)(7) or (8) of this section, if applicable), and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the instrument to the holder (translated into functional currency). See paragraph (b)(3)(iii) of this section for translation rules.

(v) *Amount realized*. The amount realized by a holder and the repurchase price paid by the issuer on the scheduled or unscheduled retirement of a debt instrument described in paragraph (a)(1)(i) of this section are determined by applying the rules of §1.1275–4(b)(7) in the denomination currency. For example, with regard to a scheduled retirement at maturity, the holder is treated as receiving the projected amount of any contingent payment due at maturity, reduced by the amount of any negative adjustment carryforward. For purposes of translating the amount realized by the holder into functional currency, the rules of paragraph (b)(3)(iv) of this section shall apply.

(3) *Treatment and translation of amounts determined under noncontingent bond method*—(i) *Accrued interest*. The amount of accrued interest, determined under paragraph (b)(2)(i) of this section, is translated into the taxpayer's functional currency at the average exchange rate, as described in §1.988–2(b)(2)(iii)(A), or, at the taxpayer's election, at the appropriate spot rate, as described in §1.988–2(b)(2)(iii)(B).

(ii) *Net positive and negative adjustments*—(A) *Net positive adjustments*. A net positive adjustment, as referenced in paragraph (b)(2)(ii) of this section, is translated into the taxpayer's functional currency at the spot rate on the last day of the taxable year in which the adjustment is taken into account under §1.1275–4(b)(6), or, if earlier, the date the instrument is disposed of or otherwise terminated.

(B) *Net negative adjustments.* A net negative adjustment is treated and, where necessary, is translated from the denomination currency into the taxpayer's functional currency under the following rules:

(*1*) The amount of a net negative adjustment determined in the denomination currency that reduces the current year's interest in that currency shall first reduce the current year's accrued but unpaid interest, and then shall reduce the current year's interest which was accrued and paid. No translation is required.

(*2*) The amount of a net negative adjustment treated as ordinary income or loss under §1.1275–4(b)(6)(iii)(B) first is attributable to accrued but unpaid interest accrued in prior taxable years. For this purpose, the net negative adjustment shall be treated as attributable to any unpaid interest accrued in the immediately preceding taxable year, and thereafter to unpaid interest accrued in each preceding taxable year. The amount of the net negative adjustment applied to accrued but unpaid interest is translated into functional currency at the same rate used, in each of the respective prior taxable years, to translate the accrued interest.

(*3*) Any amount of the net negative adjustment remaining after the application of paragraphs (b)(3)(ii)(B)(*1*) and (*2*) of this section is attributable to interest accrued and paid in prior taxable years. The amount of the net negative adjustment applied to such amounts is translated into functional currency at the spot rate on the date the debt instrument was issued or, if later, acquired.

(*4*) Any amount of the net negative adjustment remaining after application of paragraphs (b)(3)(ii)(B)(*1*), (*2*) and (*3*) of this section is a negative adjustment carryforward, within the meaning of §1.1275–4(b)(6)(iii)(C). A negative adjustment carryforward is carried forward in the denomination currency and is applied to reduce interest accruals in subsequent years. In the year in which the instrument is sold, exchanged or retired, any negative adjustment carryforward not applied to interest reduces the holder's amount realized on the instrument (in the denomination currency). An issuer of a debt instrument described in paragraph (a)(1)(i) of this section who takes into income a negative adjustment carryforward (that is not applied to interest) in the year the instrument is retired, as described in §1.1275–4(b)(6)(iii)(C), translates such income into functional currency at the spot rate on the date the instrument was issued.

(iii) *Adjusted basis*—(A) *In general*. Except as otherwise provided in this paragraph and paragraphs (b)(7) or (8) of this section, a holder determines and maintains adjusted basis by translating the denomination currency amounts determined under §1.1275–4(b)(7)(iii) into functional currency as follows:

(*1*) The holder's initial basis in the instrument is determined by translating the amount paid by the holder to acquire the instrument (in the denomination currency) into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(*2*) An increase in basis attributable to interest accrued on the instrument is translated at the rate applicable to such interest under paragraph (b)(3)(i) of this section.

(*3*) Any noncontingent payment and the projected amount of any contingent payments determined in the denomination currency that decrease the holder's basis in the instrument under §1.1275–4(b)(7)(iii) are translated as follows:

(*i*) The payment first is attributable to the most recently accrued interest to which prior amounts have not already been attributed. The payment is translated into functional currency at the rate at which the interest was accrued.

(*ii*) Any amount remaining after the application of paragraph (b)(3)(iii)(A)(*3*)(*i*) of this section is attributable to principal. Such amounts are translated into functional currency at the spot rate on the date the instrument was issued or, if later, acquired.

(B) *Exception for interest reduced by a negative adjustment carryforward*. Solely for purposes of this §1.988–6, any amounts of accrued interest income that are reduced as a result of a negative adjustment carryforward shall be treated as principal and translated at the spot rate on the date the instrument was issued or, if later, acquired.

(iv) *Amount realized*—(A) *Instrument held to maturity*—(*1*) *In general*. With respect to an instrument held to maturity, a holder translates the amount realized by separating such amount in the denomination currency into the component parts of interest and principal that make up adjusted basis prior to translation under paragraph (b)(3)(iii) of this section, and translating each of those component parts of the amount realized at the same rate used to translate the respective component parts

of basis under paragraph (b)(3)(iii) of this section. The amount realized first shall be translated by reference to the component parts of basis consisting of accrued interest during the taxpayer's holding period as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a last in first out basis. Any remaining portion of the amount realized shall be translated by reference to the rate used to translate the component of basis consisting of principal as determined under paragraph (b)(3)(iii) of this section.

(*2*) *Subsequent purchases at discount and fixed but deferred contingent payments*. For purposes of this paragraph (b)(3)(iv) of this section, any amount which is required to be added to adjusted basis under paragraph (b)(7) or (8) of this section shall be treated as additional interest which was accrued on the date the amount was added to adjusted basis. To the extent included in amount realized, such amounts shall be translated into functional currency at the same rates at which they were translated for purposes of determining adjusted basis. See paragraphs (b)(7)(iv) and (b)(8) of this section for rules governing the rates at which the amounts are translated for purposes of determining adjusted basis.

(B) *Sale, exchange, or unscheduled retirement*—(*1*) *Holder*. In the case of a sale, exchange, or unscheduled retirement, application of the rule stated in paragraph (b)(3)(iv)(A) of this section shall be as follows. The holder's amount realized first shall be translated by reference to the principal component of basis as determined under paragraph (b)(3)(iii) of this section, and then to the component of basis consisting of accrued interest as determined under paragraph (b)(3)(iii) of this section and ordering such amounts on a first in first out basis. Any gain recognized by the holder (*i.e.*, any excess of the sale price over the holder's basis, both expressed in the denomination currency) is translated into functional currency at the spot rate on the payment date.

(*2*) *Issuer*. In the case of an unscheduled retirement of the debt instrument, any excess of the adjusted issue price of the debt instrument over the amount paid by the issuer (expressed in denomination currency) shall first be attributable to accrued unpaid interest, to the extent the accrued unpaid interest had not been previously offset by a negative adjustment, on a last-in-first-out basis, and then to principal. The accrued unpaid interest shall be translated into functional currency at the rate at which the interest was accrued. The principal shall be translated at the spot rate on the date the debt instrument was issued.

(C) *Effect of negative adjustment carryforward with respect to the issuer*. Any amount of negative adjustment carryforward treated as ordinary income under §1.1275–4(b)(6)(iii)(C) shall be translated at the exchange rate on the day the debt instrument was issued.

(4) *Determination of gain or loss not attributable to foreign currency*. A holder of a debt instrument described in paragraph (a)(1)(i) of this section shall recognize gain or loss upon sale, exchange, or retirement of the instrument equal to the difference between the amount realized with respect to the instrument, translated into functional currency as described in paragraph (b)(3)(iv) of this section, and the adjusted basis in the instrument, determined and maintained in functional currency as described in paragraph (b)(3)(iii) of this section. The amount of any gain or loss so determined is characterized as provided in §1.1275–4(b)(8), and sourced as provided in paragraph (b)(6) of this section.

(5) *Determination of foreign currency gain or loss*—(i) *In general*. Other than in a taxable disposition of the debt instrument, foreign currency gain or loss is recognized with respect to a debt instrument described in paragraph (a)(1)(i) of this section only when payments are made or received. No foreign currency gain or loss is recognized with respect to a net positive or negative adjustment, as determined under paragraph (b)(2)(ii) of this section (except with respect to a positive adjustment described in paragraph (b)(8) of this section). As described in this paragraph (b)(5), foreign currency gain or loss is determined in accordance with the rules of §1.988–2(b).

(ii) *Foreign currency gain or loss attributable to accrued interest*. The amount of foreign currency gain or loss recognized with respect to payments of interest previously accrued on the instrument is determined by translating the amount of interest paid or received into functional currency at the spot rate on the date of payment and subtracting from such amount the amount determined by translating the interest paid or received into functional currency at the rate at which such interest was accrued under the rules of paragraph (b)(3)(i) of this section. For purposes of this paragraph, the amount of any payment that is treated as accrued interest shall be reduced by the amount of any net negative adjustment treated as ordinary loss (to the holder) or ordinary income (to the issuer), as provided in paragraph (b)(2)(ii) of this section. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iii) *Principal*. The amount of foreign currency gain or loss recognized with respect to payment or receipt of principal is determined by translating the amount paid or received into functional currency at the spot rate on the date of payment or receipt and subtracting from such amount the amount determined by translating the principal into functional currency at the spot rate on the date the instrument was issued or, in case of the holder, if later, acquired. For purposes of determining whether the payment consists of interest or principal, see the payment ordering rules in paragraph (b)(5)(iv) of this section.

(iv) *Payment ordering rules*—(A) *In general*. Except as provided in paragraph (b)(5)(iv)(B) of this section, payments with respect to an instrument described in paragraph (a)(1)(i) of this section shall be treated as follows:

(*1*) A payment shall first be attributable to any net positive adjustment on the instrument that has not previously been taken into account.

(*2*) Any amount remaining after applying paragraph (b)(5)(iv)(A)(*1*) of this section shall be attributable to accrued but unpaid interest, remaining after reduction by any net negative adjustment, and shall be attributable to the most recent accrual period to the extent prior amounts have not already been attributed to such period.

(*3*) Any amount remaining after applying paragraphs (b)(5)(iv)(A)(*1*) and (*2*) of this section shall be attributable to principal. Any interest paid in the current year that is reduced by a net negative adjustment shall be considered a payment of principal for purposes of determining foreign currency gain or loss.

(B) *Special rule for sale or exchange or unscheduled retirement*. Payments made

or received upon a sale or exchange or unscheduled retirement shall first be applied against the principal of the debt instrument (or in the case of a subsequent purchaser, the purchase price of the instrument in denomination currency) and then against accrued unpaid interest (in the case of a holder, accrued while the holder held the instrument).

(C) *Subsequent purchaser that has a positive adjustment allocated to a daily portion of interest*. A positive adjustment that is allocated to a daily portion of interest pursuant to paragraph (b)(7)(iv) of this section shall be treated as interest for purposes of applying the payment ordering rule of this paragraph (b)(5)(iv).

(6) *Source of gain or loss*. The source of foreign currency gain or loss recognized with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.988–4. Consistent with the rules of §1.1275–4(b)(8), all gain (other than foreign currency gain) on an instrument described in paragraph (a)(1)(i) of this section is treated as interest income for all purposes. The source of an ordinary loss (other than foreign currency loss) with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.1275–4(b)(9)(iv). The source of a capital loss with respect to an instrument described in paragraph (a)(1)(i) of this section shall be determined pursuant to §1.865–1(b)(2).

(7) *Basis different from adjusted issue price*—(i) *In general*. The rules of §1.1275–4(b)(9)(i), except as set forth in this paragraph (b)(7), shall apply to an instrument described in paragraph (a)(1)(i) of this section purchased by a subsequent holder for more or less than the instrument's adjusted issue price.

(ii) *Determination of basis*. If an instrument described in paragraph (a)(1)(i) of this section is purchased by a subsequent holder, the subsequent holder's initial basis in the instrument shall equal the amount paid by the holder to acquire the instrument, translated into functional currency at the spot rate on the date of acquisition.

(iii) *Purchase price greater than adjusted issue price*. If the purchase price of the instrument (determined in the denomination currency) exceeds the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(B), reasonably allocate such excess to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the excess shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a negative adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the rate used to translate the interest which is offset by the negative adjustment. To the extent related to a projected payment, such excess shall be treated as a negative adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is reduced by the amount treated as a negative adjustment under this paragraph (b)(7)(iii), translated into functional currency at the spot rate on the date the instrument was acquired.

(iv) *Purchase price less than adjusted issue price*. If the purchase price of the instrument (determined in the denomination currency) is less than the adjusted issue price of the instrument, the holder shall, consistent with the rules of §1.1275–4(b)(9)(i)(C), reasonably allocate the difference to the daily portions of interest accrued on the instrument or to a projected payment on the instrument. To the extent attributable to interest, the difference shall be reasonably allocated over the remaining term of the instrument to the daily portions of interest accrued and shall be a positive adjustment on the dates the daily portions accrue. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the rate used to translate the interest to which it relates. For purposes of determining adjusted basis under paragraph (b)(3)(iii) of this section, such increase in adjusted basis shall be treated as an additional accrual of interest during the period to which the positive adjustment relates. To the extent related to a projected payment, such difference shall be treated as a positive adjustment on the date the payment is made. On the date of such adjustment, the holder's adjusted basis in the instrument is increased by the amount treated as a positive adjustment under this paragraph (b)(7)(iv), translated into functional currency at the spot rate on the date the adjustment is taken into account. For purposes of determining the amount realized on the instrument in functional currency under paragraph (b)(3)(iv) of this section, amounts attributable to the excess of the adjusted issue price of the instrument over the purchase price of the instrument shall be translated into functional currency at the same rate at which the corresponding adjustments are taken into account under this paragraph (b)(7)(iv) for purposes of determining the adjusted basis of the instrument.

(8) *Fixed but deferred contingent payments*. In the case of an instrument with a contingent payment that becomes fixed as to amount before the payment is due, the rules of §1.1275–4(b)(9)(ii) shall be applied in the denomination currency of the instrument. For this purpose, foreign currency gain or loss shall be recognized on the date payment is made or received with respect to the instrument under the principles of paragraph (b)(5) of this section. Any increase or decrease in basis required under §1.1275–4(b)(9)(ii)(D) shall be taken into account at the same exchange rate as the corresponding net positive or negative adjustment is taken into account.

(c) *Examples*. The provisions of paragraph (b) of this section may be illustrated by the following examples. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes. The examples are as follows:

Example 1. Treatment of net positive adjustment—(i) *Facts*. On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a zero-coupon debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under paragraph (b)(2)(i) of this section and §1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule, as constructed under the rules of §1.1275–4(b), provides for a single payment of

£1210 on December 31, 2006 (consisting of a noncontingent payment of £975 and a projected payment of £235). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00=$1.00
Dec. 31, 2005	£1.00=$1.10
Dec. 31, 2006	£1.00=$1.20

Accrual Period	Average rate (pounds to dollars)
2005	£1.00=$1.05
2006	£1.00=$1.15

(ii) *Treatment in 2005*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2005 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($1.05 x £100 = $105). Accordingly, Z has interest income in 2005 of $105.

(B) *Adjusted issue price and basis*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x £1000 original cost basis) is increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2005. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2006, is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £110 of interest on the debt instrument for 2006 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £110 at the average exchange rate for the accrual period ($1.15 x £110 = $126.50). Accordingly, Z has interest income in 2006 of $126.50.

(B) *Effect of net positive adjustment*. The payment actually made on December 31, 2006, is £1300, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net positive adjustment of £90 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(3)(ii)(A) of this section, the £90 net positive adjustment is treated as additional interest income and is translated into dollars at the spot rate on the last day of the year ($1.20 x £90 = $108). Accordingly, Z has a net positive adjustment of $108 resulting in a total interest inclusion for 2006 of $234.50 ($126.50 + $108 = $234.50).

(C) *Adjusted issue price and basis*. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payment and the projected amount of the contingent payment to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized*. Even though Z receives £1300 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1210 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1210 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1210 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £1000 of the £1210 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Z's total amount realized is $1231.50, the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss*. Under paragraph (b)(5) of this section Z recognizes foreign currency gain under section 988 on the instrument with respect to the consideration actually received at maturity (except for the net positive adjustment), £1210. The amount of recognized foreign currency gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in 2005, the foreign currency gain is $15 [£100 x ($1.20 - $1.05)]. With respect to interest accrued in 2006, the foreign currency gain equals $5.50 [£110 x ($1.20 - $1.15)]. With respect to principal, the foreign currency gain is $200 [£1000 x ($1.20 - $1.00)]. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $220.50.

(F) *Source*. Z has interest income of $105 in 2005, interest income of $234.50 in 2006 (attributable to £110 of accrued interest and the £90 net positive adjustment), and a foreign currency gain of $220.50 in 2006. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $220.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 2. Treatment of net negative adjustment—(i) *Facts*. Assume the same facts as in *Example 1*, except that Z receives £975 at maturity instead of £1300.

(ii) *Treatment in 2005*. The treatment of the debt instrument in 2005 is the same as in *Example 1*. Thus, Z has interest income in 2005 of $105. On January 1, 2006, the adjusted issue price of the debt instrument is £1100, and Z's adjusted basis in the instrument is $1105.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section and based on the comparable yield, Z's accrued interest for 2006 is £110 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($1.15 x £110 = $126.50).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £975, rather than the projected £1210. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £235 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £125 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2005. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.05). Accordingly, Z has an ordinary loss of $105 in 2006. The remaining £25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1210 (£1100 plus £110 of accrued interest for 2006). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1231.50 ($1105 plus $126.50 of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives £975 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £25. Therefore, Z is treated as receiving £1185 (£1210 - £25) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £100 of the £1185 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.05), resulting in an amount realized of $105; £110 of the £1185 (representing the interest accrued in 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.15), resulting in an amount realized of $126.50; and £975 of the £1185 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $975. Z's amount realized is $1206.50 ($105 + $126.50 + $975 = $1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $25 on retirement of the instrument ($1206.50 - $1231.50 = -$25).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the consideration actually received at maturity, £975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only. Thus, Z recognizes a total foreign currency gain on December 31, 2006, of $195 [£975 x ($1.20 - $1.00)].

(F) *Source.* In 2006, Z has an ordinary loss of $105, a capital loss of $25, and a foreign currency gain of $195. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $105 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $25 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $195 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 3. Negative adjustment and periodic interest payments—(i) *Facts.* On December 31, 2004, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases from a foreign corporation, at original issue, a two-year debt instrument with a non-currency contingency for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of £30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal £1086.20 (consisting of a noncontingent payment of £980 and a projected payment of £106.20) in addition to the interest payable at maturity. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £981.00. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2004	£1.00=$1.00
June 30, 2005	£1.00=$1.20
Dec. 31, 2005	£1.00=$1.40
June 30, 2006	£1.00=$1.60
Dec. 31, 2006	£1.00=$1.80

Accrual Period	Average rate (pounds to dollars)
Jan.–June 2005	£1.00=$1.10
July–Dec. 2005	£1.00=$1.30
Jan.–June 2006	£1.00=$1.50
July–Dec. 2006	£1.00=$1.70

(ii) *Treatment in 2005*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £50 of interest on the debt instrument for the January-June accrual period (issue price of £1000 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £50 at the average exchange rate for the accrual period ($1.10 x £50 = $55.00). Similarly,

Z accrues £51 of interest in the July-December accrual period [(£1000 + £50 - £30) x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.30 x £51 = $66.30). Accordingly, Z accrues $121.30 of interest income in 2005.

(B) *Adjusted issue price and basis—(1) January–June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is £1020 (£1000 + £50 - £30 = £1020). For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis is increased by the £50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.10 x £50 = $55). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.10 x £30 = $33). Accordingly, Z's adjusted basis as of July 1, 2005, is $1022 ($1000 + $55 - $33).

(*2*) *July–December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is £1041 (£1020 + £51 - £30 = £1041). For purposes of determining Z's dollar basis in the debt instrument, the $1022 basis is increased by the £51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.30 x £51 = $66.30). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.30 x £30 = $39). Accordingly, Z's adjusted basis as of January 1, 2006, is $1049.30 ($1022 + $66.30 - $39).

(C) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of each £30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by reference to the difference between the spot rate on the date the £30 payment was made and the average exchange rate for the accrual period during which the interest accrued. Accordingly, Z recognizes $3 of foreign currency gain on the January-June interest payment [£30 x ($1.20 - $1.10)], and $3 of foreign currency gain on the July-December interest payment [£30 x ($1.40 - $1.30)]. Z recognizes in 2005 a total of $6 of foreign currency gain.

(D) *Source.* Z has interest income of $121.30 and a foreign currency gain of $6. Under paragraph (b)(6) of this section and section 862(a)(1), the interest income is sourced by reference to the residence of the payor and is therefore from sources without the United States. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $6 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iii) *Treatment in 2006*—(A) *Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for the January-June accrual period is £52.05 (adjusted issue price of £1041 x 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £52.05 at the average exchange rate for the accrual period ($1.50 x £52.05 = $78.08). Similarly, Z accrues £53.15 of interest in the July-December accrual period [(£1041 + £52.05 - £30) x 10 percent/2], which is translated at the average exchange rate for the accrual period ($1.70 x £53.15 = $90.35). Accordingly, Z accrues £105.20, or $168.43, of interest income in 2006.

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £981.00, rather than the projected £1086.20. Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of £105.20 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £105.20 in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) *Adjusted issue price and basis—(1) January–June accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the January-June accrual period. Thus, on July 1, 2006, the adjusted issue price of the debt instrument is £1063.05 (£1041 + £52.05 - £30 = £1063.05). For purposes of determining Z's dollar basis in the debt instrument, the $1049.30 adjusted basis is increased by the £52.05 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January-June accrual period ($1.50 x £52.05 = $78.08). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.50 x £30 = $45). Accordingly, Z's adjusted basis as of July 1, 2006, is $1082.38 ($1049.30 + $78.08 - $45).

(*2*) *July–December accrual period.* Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued, and decreased by the interest payment made, in the July-December accrual period. Thus, immediately before maturity on December 31, 2006, the adjusted issue price of the instrument is £1086.20 (£1063.05 + £53.15 - £30 = £1086.20). For purposes of determining Z's dollar basis in the debt instrument, the $1082.38 adjusted basis is increased by the £53.15 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July-December accrual period ($1.70 x £53.15 = $90.36). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and §1.988–2(b)(7), at the rate applicable to accrued interest ($1.70 x £30 = $51). Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is $1121.74 ($1082.38 + $90.36 - $51).

(D) *Amount realized.* Even though Z receives £981.00 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006. Therefore, Z is treated as receiving £1086.20 on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £20 of the £1086.20 (representing the interest accrued in the January-June 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.10), resulting in an amount realized of $22; £21 of the £1086.20 (representing the interest accrued in the July-December 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.30), resulting in an amount realized of $27.30; £22.05 of the £1086.20 (representing the interest accrued in the January-June 2006 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $33.08; £23.15 of the £1086.20 (representing the interest accrued in the July 1-December 31, 2006, accrual period, less the £30 interest payment) is translated into dollars at the rate at which it was accrued (£1 = $1.70), resulting in an amount realized of $39.36; and £1000 (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1000. Accordingly, Z's total amount realized is $1121.74 ($22 + $27.30 + $33.08 + $39.36 + $1000), the same as its basis, and Z recognizes no gain or loss (before consideration of foreign currency gain or loss) on retirement of the instrument.

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to each £30 payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(*3*) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £30 payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $18 of foreign currency gain on the January-June 2006 interest payment [£30 x ($1.60 - $1.00)], and $24 of foreign currency gain on the July-December 2006 interest payment [£30 x ($1.80 - $1.00)]. Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity, £981.00. The amount of such gain is determined based on the difference between the spot rate on the date the instrument matures and the rates at which the principal and interest were taken into account. With respect to the portion of the payment attributable to interest accrued in January-June 2005 (other than the £30 payments), the foreign currency gain is $14 [£20 x ($1.80 - $1.10)]. With respect to the portion of the payment attributable to interest accrued in July-December 2005 (other than the

£30 payments), the foreign currency gain is $10.50 [£21 x ($1.80 - $1.30)]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the £30 payments), no foreign currency gain or loss is recognized under paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is $752 [£940 x ($1.80 - $1.00)]. Thus, Z recognizes a foreign currency gain of $42 on receipt of the two £30 payments in 2006, and $776.50 ($14 + $10.50 + $752) on receipt of the payment at maturity, for a total 2006 foreign currency gain of $818.50.

(F) *Source*. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 4. Purchase price greater than adjusted issue price—(i) *Facts*. On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for £1405. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument was originally issued by a foreign corporation on December 31, 2003, for an issue price of £1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date under the rules of §1.1275–4(b)) provides for a single payment at maturity of £1349.70 (consisting of a noncontingent payment of £1000 and a projected payment of £349.70). At the time of the purchase, the adjusted issue price of the debt instrument is £1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2006, is £1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
July 1, 2005	£1.00=$1.00
Dec. 31, 2006	£1.00=$2.00

Accrual period	Average rate (pounds to dollars)
July 1– December 31, 2005	£1.00=$1.50
January 1–June 30, 2006	£1.00=$1.50
July 1–December 31, 2006	£1.00=$1.50

(ii) *Initial basis*. Under paragraph (b)(7)(ii) of this section, Z's initial basis in the debt instrument is $1405, Z's purchase price of £1405, translated into functional currency at the spot rate on the date the debt instrument was purchased (£1 = $1).

(iii) *Allocation of purchase price differential*. Z purchased the debt instrument for £1405 when its adjusted issue price was £1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the £243.24 excess of purchase price over adjusted issue price to the contingent payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) *Treatment in 2005*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £59.54 of interest on the debt instrument for the July-December 2005 accrual period (issue price of £1161.76 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £59.54 of interest at the average exchange rate for the accrual period ($1.50 x £59.54 = $89.31). Accordingly, Z has interest income in 2005 of $89.31.

(B) *Adjusted issue price and basis*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in July-December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1221.30 (£1161.76 + £59.54). For purposes of determining Z's dollar basis in the debt instrument on January 1, 2006, the $1405 basis is increased by the £59.54 of accrued interest, translated at the rate at which interest was accrued for the July-December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the instrument, as of January 1, 2006, is $1494.31 [$1405 + (£59.54 x $1.50)].

(v) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £62.59 of interest on the debt instrument for the January-June 2006 accrual period (issue price of £1221.30 x 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £62.59 of accrued interest at the average exchange rate for the accrual period ($1.50 x £62.59 = $93.89). Similarly, Z accrues £65.80 of interest in the July-December 2006 accrual period [(£1221.30 + £62.59) x 10.25 percent/2], which is translated at the average exchange rate for the accrual period ($1.50 x £65.80 = $98.70). Accordingly, Z accrues £128.39, or $192.59, of interest income in 2006.

(B) *Effect of positive and negative adjustments*—(*1*) *Offset of positive adjustment.* The payment actually made on December 31, 2006, is £1400, rather than the projected £1349.70. Under paragraph (b)(2)(ii) of this section, Z has a positive adjustment of £50.30 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Under paragraph (b)(7)(iii) of this section, however, Z also has a negative adjustment of £243.24, attributable to the excess of Z's purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of £192.94 (£50.30 - £243.24 = -£192.94) for 2006.

(*2*) *Offset of accrued interest*. Z's accrued interest income of £128.39 in 2006 is reduced to zero by the net negative adjustment. The net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £64.55 net negative adjustment as an ordinary loss to the extent of the £59.54 previously accrued interest in 2005. This £59.54 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $1.50). Accordingly, Z has an ordinary loss of $89.31 in 2006. The remaining £5 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis*—(*1*) *January–June accrual period*. Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument on July 1, 2006, is £1283.89

(£1221.30 + £62.59 = £1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is $1588.20 ($1494.31 + $93.89).

(*2*) *July–December accrual period*. Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1349.70 (£1283.89 + £65.80 accrued interest for July-December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $1686.90 ($1588.20 plus $98.70 of accrued interest for July-December).

(*3*) *Adjustment to basis upon contingent payment*. Under paragraph (b)(7)(iii) of this section, Z's adjusted basis in the debt instrument is reduced at maturity by £243.24, the excess of Z's purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (£1 = $1). Accordingly, Z's adjusted basis in the debt instrument at maturity is $1443.66 ($1686.90 - $243.24).

(D) *Amount realized*. Even though Z receives £1400 at maturity, for purposes of determining the amount realized, Z is treated under paragraph (b)(2)(v) of this section as receiving the projected amount of the contingent payment on December 31, 2006, reduced by the amount of Z's negative adjustment carryforward of £5.01. Therefore, Z is treated as receiving £1344.69 (£1349.70 - £5.01) on December 31, 2006. Under paragraph (b)(3)(iv) of this section, Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign currency gain or loss) by breaking the amount realized into its component parts. Accordingly, £59.54 of the £1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $89.31; £62.59 of the £1344.69 (representing the interest accrued in January-June 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $93.89; £65.80 of the £1344.69 (representing the interest accrued in July-December 2006) is translated into dollars at the rate at which it was accrued (£1 = $1.50), resulting in an amount realized of $98.70; and £1156.76 of the £1344.69 (representing a return of principal) is translated into dollars at the spot rate on the date the instrument was purchased (£1 = $1), resulting in an amount realized of $1156.76. Z's amount realized is $1438.66 ($89.31 + $93.89 + $98.70 + $1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of $5 on retirement of the instrument ($1438.66 - $1443.66 = -$5).

(E) *Foreign currency gain or loss*. Z recognizes foreign currency gain under section 988 on the instrument with respect to the entire consideration actually received at maturity, £1400. While foreign currency gain or loss ordinarily would not have arisen with respect to £50.30 of the £1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire £1400. Under paragraph (b)(5)(ii) of this section, however, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Therefore, the entire £1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of $1400 [£1400 x ($2.00 - $1.00)].

(F) *Source*. Z has an ordinary loss of $89.31, a capital loss of $5, and a foreign currency gain of $1400. Under paragraph (b)(6) of this section and §1.1275–4(b)(9)(iv), the $89.31 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.865–1(b)(2), the $5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the $5 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 5. Sale of an instrument with a negative adjustment carryforward—(i) *Facts*. On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies for £1000. All payments of principal and interest with respect to the instrument are denominated in, or determined by reference to, a single nonfunctional currency (the British pound). The debt instrument would be subject to §1.1275–4(b) if it were denominated in dollars. The debt instrument's comparable yield, determined in British pounds under §§1.988–2(b)(2) and 1.1275–4(b), is 10 percent, compounded annually, and the projected payment schedule for the debt instrument provides for payments of £310 on December 31, 2005 (consisting of a noncontingent payment of £50 and a projected amount of £260) and £990 on December 31, 2006 (consisting of a noncontingent payment of £940 and a projected amount of £50). The debt instrument is a capital asset in the hands of Z. Z does not elect to use the spot-rate convention described in §1.988–2(b)(2)(iii)(B). The payment actually made on December 31, 2005, is £50. On December 30, 2006, Z sells the debt instrument for £940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2003	£1.00=$1.00
Dec. 31, 2005	£1.00=$2.00
Dec. 31, 2006	£1.00=$2.00

Accrual period	Average rate (pounds to dollars)
January 1–December 31, 2004	£1.00=$2.00
January 1–December 31, 2005	£1.00=$2.00
January 1–December 31, 2006	£1.00=$2.00

(ii) *Treatment in 2004*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2004 (issue price of £1000 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ($2.00 x £100 = $200). Accordingly, Z has interest income in 2004 of $200.

(B) *Adjusted issue price and basis*. Under paragraphs (b)(2)(iii) and (iv) of this section, the adjusted issue price of the debt instrument determined in pounds and Z's adjusted basis in dollars in the debt instrument are increased by the interest accrued in 2004. Thus, on January 1, 2005, the adjusted issue price of the debt instrument is £1100. For purposes of determining Z's dollar basis in the debt instrument, the $1000 basis ($1.00 x £1000 original cost basis) is

increased by the £100 of accrued interest, translated at the rate at which interest was accrued for 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is $1200 ($1000 + $200).

(iii) *Treatment in 2005*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is £110 (adjusted issue price of £1100 x 10 percent). Under paragraph (b)(3)(i) of this section, the £110 of accrued interest is translated at the average exchange rate for the accrual period ($2.00 x £110 = $220).

(B) *Effect of net negative adjustment*. The payment actually made on December 31, 2005, is £50, rather than the projected £310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2005 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(*1*) of this section, the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £150 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2004. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(*2*) of this section, Z translates the loss into dollars at the average rate for such year (£1 = $2.00). Accordingly, Z has an ordinary loss of $200 in 2005. The remaining £50 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis*. Based on the projected payment schedule, the adjusted issue price of the debt instrument on January 1, 2006, is £900, *i.e.*, the adjusted issue price of the debt instrument on January 1, 2005 (£1100), increased by the interest accrued in 2005 (£110), and decreased by the projected amount of the December 31, 2005, payment (£310). See paragraph (b)(2)(iii) of this section. Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is $900 (determined as described below). Z's adjusted basis on January 1, 2006, is Z's adjusted basis on January 1, 2005 ($1200), increased by the functional currency amount of interest accrued in 2005 ($220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (£310). The amount of the projected payment is first attributable to the interest accrued in 2005 (£110), and then to the interest accrued in 2004 (£100), and the remaining amount to principal (£100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ($1200 + $220 = $1420), is decreased by $520 ($220 + $200 + $100 = $520). Z's adjusted basis on January 1, 2006, is therefore, $900.

(D) *Foreign currency gain or loss*. Z will recognize foreign currency gain on the receipt of the £50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the £50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes $50 of foreign currency gain on the £50 payment. [($2.00 - $1.00) x £50 =$50]. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) *Treatment in 2006*—(A) *Determination of accrued interest*. Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £90 of interest on the debt instrument for 2004 (adjusted issue price of £900 x 10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £90 at the average exchange rate for the accrual period ($2.00 x £90 = $180). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of $180.

(B) *Effect of net negative adjustment*. The £50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a £50 negative adjustment in 2006 which reduces Z's accrued interest income by £50. Accordingly, after giving effect to the £50 negative adjustment carryforward, Z will accrue $80 of interest income. [(£90-£50) x $2.00 = $80]

(C) *Adjusted issue price*. Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is £990.

(D) *Adjusted basis*. For purposes of determining Z's dollar basis in the debt instrument, Z's $900 adjusted basis on January 1, 2006, is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) the amount of accrued interest which is reduced as a result of the negative adjustment carryforward, *i.e.*, £50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, *i.e.*, £1.00 =$1.00. Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is $1030 ($900 + $50 + $80).

(E) *Amount realized*. Z's amount realized in denomination currency is £940, *i.e.*, the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(*1*) of this section, Z's amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, £900 of Z's amount realized is translated by reference to the principal component of adjusted basis. The remaining £40 of Z's amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also is translated by reference to the principal component of adjusted basis. Accordingly, Z's amount realized in functional currency is $940. (No part of Z's amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of $90 on the sale of the debt instrument ($1030 basis - $940 amount realized). Under paragraph (b)(4) of this section and §1.1275–4(b)(8), $80 of the loss is characterized as ordinary loss, and the remaining $10 of loss is characterized as capital loss. Under §§1.988–6(b)(6) and 1.1275–4(b)(9)(iv) the $80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under §§1.988–6(b)(6) and 1.865–1(b)(2) the $10 capital loss is also allocated to the interest income from the debt instrument.

(F) *Foreign currency gain or loss*. Z recognizes foreign currency gain with respect to the £940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the £940 Z received is attributable to principal (and the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of $940. [($2.00-$1.00) x £940]. Under paragraph (b)(6) of this section and §1.988–4, Z's foreign currency gain of $940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) *Multicurrency debt instruments*—(1) *In general*. Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) *Determination of denomination currency*. The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. The predominant currency of the instrument shall be determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary)

into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (*e.g.*, changes in value of one or more currencies).

(3) *Issuer/holder consistency*. The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of §1.1275–2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer's determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) *Treatment of payments in currencies other than the denomination currency*. For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as non-currency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer's functional currency, the instrument shall be accounted for under §1.1275–4(b) rather than this section.

(e) *Instruments issued for nonpublicly traded property*—(1) *Applicability*. This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in §1.1275–4(c)(1) rather than §1.1275–4(b)(1). For example, this paragraph (e) generally applies to a contingent debt instrument denominated in a nonfunctional currency that is issued for non-publicly traded property. Generally the rules of §1.1275–4(c) apply except as set forth by the rules of this paragraph (e).

(2) *Separation into components*. An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of §1.1275–4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) *Treatment of components consisting of one or more noncontingent payments in the same currency*. The issue price of each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under §1.1274–2(c)(2), and the test rate shall be determined under §1.1274–4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are qualified stated interest payments (within the meaning of §1.1273–1(c)) and the *de minimis* rules of section 1273(a)(3) and §1.1273–1(d) do not apply to the separate debt instrument. Interest income or expense is translated, and exchange gain or loss is recognized on the separate debt instrument as provided in §1.988–2(b)(2), if the instrument is denominated in a nonfunctional currency.

(4) *Treatment of components consisting of contingent payments*—(i) *General rule*. A component consisting of a contingent payment shall generally be treated in the manner provided in §1.1275–4(c)(4). However, except as provided in paragraph (e)(4)(ii) of this section, the test rate shall be determined by reference to the U.S. dollar unless the dollar does not reasonably reflect the economic substance of the contingent component. In such case, the test rate shall be determined by reference to the currency which most reasonably reflects the economic substance of the contingent component. Any amount received in nonfunctional currency from a component consisting of a contingent payment shall be translated into functional currency at the spot rate on the date of receipt. Except in the case when the payment becomes fixed more than six months before the payment is due, no foreign currency gain or loss shall be recognized on a contingent payment component.

(ii) *Certain delayed contingent payments*—(A) *Separate debt instrument relating to the fixed component*. The rules of §1.1275–4(c)(4)(iii) shall apply to a contingent component the payment of which becomes fixed more than 6 months before the payment is due. For this purpose, the denomination currency of the separate debt instrument relating to the fixed payment shall be the currency in which payment is to be made and the test rate for such separate debt instrument shall be determined in the currency of that instrument. If the separate debt instrument relating to the fixed payment is denominated in nonfunctional currency, the rules of §1.988–2(b)(2) shall apply to that instrument for the period beginning on the date the payment is fixed and ending on the payment date.

(B) *Contingent component*. With respect to the contingent component, the issue price considered to have been paid by the issuer to the holder under §1.1275–4(c)(4)(iii)(A) shall be translated, if necessary, into the functional currency of the issuer or holder at the spot rate on the date the payment becomes fixed.

(5) *Basis different from adjusted issue price*. The rules of §1.1275–4(c)(5) shall apply to an instrument subject to this paragraph (e).

(6) *Treatment of a holder on sale, exchange, or retirement*. The rules of §1.1275–4(c)(6) shall apply to an instrument subject to this paragraph (e).

(f) *Rules for nonfunctional currency tax exempt obligations described in §1.1275–4(d)*. [RESERVED]

(g) *Effective date*. This section shall apply to debt instruments issued 60 days or more after the date final regulations are published in the **Federal Register**.

Par. 4. In §1.1275–4, paragraph (a)(2)(iv) is revised to read as follows:

§1.1275–4 Contingent payment debt instruments.

(a)***

(2)***

(iv) A debt instrument subject to section 988 (except as provided in §1.988–6);

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David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

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