

instruments. The proposed regulations followed the general approach in the then-proposed § 1.1275-4(g) contingent payment debt regulations (LR-189-84; 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, 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