

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