

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 non-publicly 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.