

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