

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 × 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 \times £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 ($\$1.00 \times £1000$ 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 × 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 \times £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 ($\$1.20 \times £90 = \108). Accordingly, Z has a net positive adjustment of \$108 resulting in a total interest inclusion for 2006 of \$234.50 ($\$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 [$£100 \times (\$1.20 - \$1.05)$]. With respect to interest accrued in 2006, the foreign currency gain equals \$5.50 [$£110 \times (\$1.20 - \$1.15)$]. With respect to principal, the foreign currency gain is \$200 [$£1000 \times (\$1.20 - \$1.00)$]. 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 × 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 \times £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