

projected payment. Z's accrued interest income of £110 in 2006 is reduced to zero by the net negative adjustment. Under paragraph (b)(3)(ii)(B)(1) of this section the net negative adjustment which reduces the current year's interest is not translated into functional currency. Under paragraph (b)(2)(ii) of this section, Z treats the remaining £125 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2005. This £100 ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, under paragraph (b)(3)(ii)(B)(2) of this section, Z translates the loss into dollars at the average rate for such year (£1 = \$1.05). Accordingly, Z has an ordinary loss of \$105 in 2006. The remaining £25 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(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 payments and the projected amount of the contingent payments to be received, is \$1231.50 (\$1105 plus \$126.50 of accrued interest for 2006).

(D) *Amount realized.* Even though Z receives \$975 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, reduced by the amount of Z's negative adjustment carryforward of £25. Therefore, Z is treated as receiving £1185 (£1210 - £25) 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 £1185 (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 £1185 (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 \$975 of the £1185 (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 \$975. Z's amount realized is \$1206.50 (\$105 + \$126.50 + \$975 = \$1206.50), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of \$25 on retirement of the instrument (\$1206.50 - \$1231.50 = -\$25).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the consideration actually received at maturity, \$975. Under paragraph (b)(5)(ii) of this section, no foreign currency gain or loss is recognized with respect to unpaid accrued interest reduced to zero by the net negative adjustment resulting in 2006. In addition, no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005, also reduced to zero by the ordinary loss. Accordingly, Z recognizes foreign currency gain with respect to principal only.

Thus, Z recognizes a total foreign currency gain on December 31, 2006, of \$195 [\$975 × (\$1.20 - \$1.00)].

(F) *Source.* In 2006, Z has an ordinary loss of \$105, a capital loss of \$25, and a foreign currency gain of \$195. Under paragraph (b)(6) of this section and § 1.1275-4(b)(9)(iv), the \$105 ordinary loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and § 1.865-1(b)(2), the \$25 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the \$25 capital loss generally reduces Z's foreign source passive income under section 904(d) and the regulations thereunder. Under paragraph (b)(6) of this section and § 1.988-4, Z's foreign currency gain of \$195 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 3. Negative adjustment and periodic interest payments—(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 two-year 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 §§ 1.988-2(b)(2) and 1.1275-4(b), is 10 percent, compounded semiannually. The debt instrument provides for semiannual interest payments of £30 payable each June 30, and December 31, and a contingent payment at maturity on December 31, 2006, which is projected to equal £1086.20 (consisting of a noncontingent payment of £980 and a projected payment of £106.20) in addition to the interest payable at maturity. 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 £981.00. 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
June 30, 2005	£1.00=\$1.20
Dec. 31, 2005	£1.00=\$1.40
June 30, 2006	£1.00=\$1.60
Dec. 31, 2006	£1.00=\$1.80

Accrual period	Average rate (pounds to dollars)
Jan.–June 2005	£1.00=\$1.10
July–Dec. 2005	£1.00=\$1.30
Jan.–June 2006	£1.00=\$1.50
July–Dec. 2006	£1.00=\$1.70

(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 £50 of interest on the debt instrument for the January–June accrual period (issue price of £1000 × 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £50 at the average exchange rate for the accrual period ($\$1.10 \times £50 = \55.00). Similarly, Z accrues £51 of interest in the July–December accrual period [$(£1000 + £50 - £30) \times 10 \text{ percent}/2$], which is translated at the average exchange rate for the accrual period ($\$1.30 \times £51 = \66.30). Accordingly, Z accrues £121.30 of interest income in 2005.

(B) *Adjusted issue price and basis—(1) January–June accrual period.* 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, and decreased by the interest payment made, in the January–June accrual period. Thus, on July 1, 2005, the adjusted issue price of the debt instrument is £1020 (£1000 + £50 - £30 = £1020). For purposes of determining Z's dollar basis in the debt instrument, the \$1000 basis is increased by the £50 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the January–June accrual period ($\$1.10 \times £50 = \55). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and § 1.988-2(b)(7), at the rate applicable to accrued interest ($\$1.10 \times £30 = \33). Accordingly, Z's adjusted basis as of July 1, 2005, is \$1022 (\$1000 + \$55 - \$33).

(2) *July–December accrual period.* 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, and decreased by the interest payment made, in the July–December accrual period. Thus, on January 1, 2006, the adjusted issue price of the instrument is £1041 (£1020 + £51 - £30 = £1041). For purposes of determining Z's dollar basis in the debt instrument, the \$1022 basis is increased by the £51 of accrued interest, translated, under paragraph (b)(3)(iii) of this section, at the rate at which interest was accrued for the July–December accrual period ($\$1.30 \times £51 = \66.30). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and § 1.988-2(b)(7), at the rate applicable to accrued interest ($\$1.30 \times £30 = \39). Accordingly, Z's adjusted basis as of January 1, 2006, is \$1049.30 (\$1022 + \$66.30 - \$39).

(C) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of each £30 payment of interest actually received during 2005. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(ii) of this section, by reference to the difference between the spot rate on the date the £30 payment was made and the average exchange