

rate for the accrual period during which the interest accrued. Accordingly, Z recognizes \$3 of foreign currency gain on the January–June interest payment [$\$30 \times (\$1.20 - \$1.10)$], and \$3 of foreign currency gain on the July–December interest payment [$\$30 \times (\$1.40 - \$1.30)$]. Z recognizes in 2005 a total of \$6 of foreign currency gain.

(D) *Source.* Z has interest income of \$121.30 and a foreign currency gain of \$6. 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 \$6 is sourced by reference to Z's residence and is therefore from sources within the United States.

(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 the January–June accrual period is £52.05 (adjusted issue price of £1041 \times 10 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £52.05 at the average exchange rate for the accrual period ($\$1.50 \times \text{£}52.05 = \78.08). Similarly, Z accrues £53.15 of interest in the July–December accrual period [$(\text{£}1041 + \text{£}52.05 - \text{£}30) \times 10 \text{ percent}/2$], which is translated at the average exchange rate for the accrual period ($\$1.70 \times \text{£}53.15 = \90.35). Accordingly, Z accrues £105.20, or \$168.43, of interest income in 2006.

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2006, is £981.00, rather than the projected £1086.20. Under paragraph (b)(2)(ii)(B) of this section, Z has a net negative adjustment of £105.20 on December 31, 2006, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £105.20 in 2006 is reduced to zero by the net negative adjustment. Elimination of the 2006 accrued interest fully utilizes the net negative adjustment.

(C) *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, 2006, the adjusted issue price of the debt instrument is £1063.05 ($\text{£}1041 + \text{£}52.05 - \text{£}30 = \text{£}1063.05$). For purposes of determining Z's dollar basis in the debt instrument, the \$1049.30 adjusted basis is increased by the £52.05 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 ($\$1.50 \times \text{£}52.05 = \78.08). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and § 1.988–2(b)(7), at the rate applicable to accrued interest ($\$1.50 \times \text{£}30 = \45). Accordingly, Z's adjusted basis as of July 1, 2006, is \$1082.38 ($\$1049.30 + \$78.08 - \45).

(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, immediately before maturity on December 31, 2006, the adjusted issue price of the instrument is £1086.20 ($\text{£}1063.05 + \text{£}53.15 - \text{£}30 = \text{£}1086.20$). For purposes of determining Z's dollar basis in the debt instrument, the \$1082.38 adjusted basis is increased by the £53.15 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 ($\$1.70 \times \text{£}53.15 = \90.36). The resulting amount is reduced by the £30 payment of interest made during the accrual period, translated, under paragraph (b)(3)(iii) of this section and § 1.988–2(b)(7), at the rate applicable to accrued interest ($\$1.70 \times \text{£}30 = \51). Accordingly, Z's adjusted basis on December 31, 2006, immediately prior to maturity is \$1121.74 ($\$1082.38 + \$90.36 - \51).

(D) *Amount realized.* Even though Z receives £981.00 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 £1086.20 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, £20 of the £1086.20 (representing the interest accrued in the January–June 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued ($\text{£}1 = \$1.10$), resulting in an amount realized of \$22; £21 of the £1086.20 (representing the interest accrued in the July–December 2005 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued ($\text{£}1 = \$1.30$), resulting in an amount realized of \$27.30; £22.05 of the £1086.20 (representing the interest accrued in the January–June 2006 accrual period, less £30 interest paid) is translated into dollars at the rate at which it was accrued ($\text{£}1 = \$1.50$), resulting in an amount realized of \$33.08; £23.15 of the £1086.20 (representing the interest accrued in the July 1–December 31, 2006 accrual period, less the £30 interest payment) is translated into dollars at the rate at which it was accrued ($\text{£}1 = \$1.70$), resulting in an amount realized of \$39.36; and £1000 (representing principal) is translated into dollars at the spot rate on the date the instrument was purchased ($\text{£}1 = \$1$), resulting in an amount realized of \$1000. Accordingly, Z's total amount realized is \$1121.74 ($\$22 + \$27.30 + \$33.08 + \$39.36 + \1000), 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.* Z recognizes foreign currency gain with respect

to each £30 payment actually received during 2006. These payments, however, are treated as payments of principal for this purpose because all 2006 accrued interest is reduced to zero by the net negative adjustment. See paragraph (b)(5)(iv)(A)(3) of this section. The amount of foreign currency gain in each case is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £30 payment is made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes \$18 of foreign currency gain on the January–June 2006 interest payment [$\$30 \times (\$1.60 - \$1.00)$], and \$24 of foreign currency gain on the July–December 2006 interest payment [$\$30 \times (\$1.80 - \$1.00)$]. Z separately recognizes foreign currency gain with respect to the consideration actually received at maturity, £981.00. The amount of such 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 January–June 2005 (other than the £30 payments), the foreign currency gain is \$14 [$\text{£}20 \times (\$1.80 - \$1.10)$]. With respect to the portion of the payment attributable to interest accrued in July–December 2005 (other than the £30 payments), the foreign currency gain is \$10.50 [$\text{£}21 \times (\$1.80 - \$1.30)$]. With respect to the portion of the payment attributable to interest accrued in 2006 (other than the £30 payments), no foreign currency gain or loss is recognized under paragraph (b)(5)(ii) of this section because such interest was reduced to zero by the net negative adjustment. With respect to the portion of the payment attributable to principal, the foreign currency gain is \$752 [$\text{£}940 \times (\$1.80 - \$1.00)$]. Thus, Z recognizes a foreign currency gain of \$42 on receipt of the two £30 payments in 2006, and \$776.50 ($\$14 + \$10.50 + \752) on receipt of the payment at maturity, for a total 2006 foreign currency gain of \$818.50.

(F) *Source.* Under paragraph (b)(6) of this section and § 1.988–4, Z's foreign currency gain of \$818.50 is sourced by reference to Z's residence and is therefore from sources within the United States.

Example 4. Purchase price greater than adjusted issue price—(i) Facts. On July 1, 2005, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases a debt instrument with a non-currency contingency for £1405. 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 was originally issued by a foreign corporation on December 31, 2003, for an issue price of £1000, and matures on December 31, 2006. The debt instrument's comparable yield, determined in British pounds under §§ 1.988–2(b)(2) and 1.1275–4(b), is 10.25 percent, compounded semiannually, and the projected payment schedule for the debt instrument (determined as of the issue date under the rules of