

§ 1.1275-4(b)) provides for a single payment at maturity of £1349.70 (consisting of a noncontingent payment of £1000 and a projected payment of £349.70). At the time of the purchase, the adjusted issue price of the debt instrument is £1161.76, assuming semiannual accrual periods ending on June 30 and December 31 of each year. The increase in the value of the debt instrument over its adjusted issue price is due to an increase in the expected amount of the contingent payment. 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 £1400. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
July 1, 2005	£1.00=\$1.00
Dec. 31, 2006	£1.00=\$2.00
Accrual period	Average rate (pounds to dollars)
July 1–December 31, 2005	£1.00=\$1.50
January 1–June 30, 2006	£1.00=\$1.50
July 1–December 31, 2006	£1.00=\$1.50

(ii) *Initial basis.* Under paragraph (b)(7)(ii) of this section, Z's initial basis in the debt instrument is \$1405, Z's purchase price of £1405, translated into functional currency at the spot rate on the date the debt instrument was purchased (£1 = \$1).

(iii) *Allocation of purchase price differential.* Z purchased the debt instrument for £1405 when its adjusted issue price was £1161.76. Under paragraph (b)(7)(iii) of this section, Z allocates the £243.24 excess of purchase price over adjusted issue price to the contingent payment at maturity. This allocation is reasonable because the excess is due to an increase in the expected amount of the contingent payment and not, for example, to a decrease in prevailing interest rates.

(iv) *Treatment in 2005—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £59.54 of interest on the debt instrument for the July–December 2005 accrual period (issue price of £1161.76 × 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £59.54 of interest at the average exchange rate for the accrual period ($\$1.50 \times £59.54 = \89.31). Accordingly, Z has interest income in 2005 of \$89.31.

(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 July–December 2005. Thus, on January 1, 2006, the adjusted issue price of the debt instrument is £1221.30 (£1161.76 + £59.54). For purposes of determining Z's dollar basis in the debt instrument on

January 1, 2006, the \$1405 basis is increased by the £59.54 of accrued interest, translated at the rate at which interest was accrued for the July–December 2005 accrual period. Paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the instrument, as of January 1, 2006, is \$1494.31 [$\$1405 + (£59.54 \times \$1.50)$].

(v) *Treatment in 2006—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £62.59 of interest on the debt instrument for the January–June 2006 accrual period (issue price of £1221.30 × 10.25 percent/2). Under paragraph (b)(3)(i) of this section, Z translates the £62.59 of accrued interest at the average exchange rate for the accrual period ($\$1.50 \times £62.59 = \93.89). Similarly, Z accrues £65.80 of interest in the July–December 2006 accrual period [$(£1221.30 + £62.59) \times 10.25 \text{ percent}/2$], which is translated at the average exchange rate for the accrual period ($\$1.50 \times £65.80 = \98.70). Accordingly, Z accrues £128.39, or \$192.59, of interest income in 2006.

(B) *Effect of positive and negative adjustments—(1) Offset of positive adjustment.* The payment actually made on December 31, 2006, is £1400, rather than the projected £1349.70. Under paragraph (b)(2)(ii) of this section, Z has a positive adjustment of £50.30 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)(7)(iii) of this section, however, Z also has a negative adjustment of £243.24, attributable to the excess of Z's purchase price for the debt instrument over its adjusted issue price. Accordingly, Z will have a net negative adjustment of £192.94 ($£50.30 - £243.24 = -£192.94$) for 2006.

(2) *Offset of accrued interest.* Z's accrued interest income of £128.39 in 2006 is reduced to zero by the net negative adjustment. 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 £64.55 net negative adjustment as an ordinary loss to the extent of the £59.54 previously accrued interest in 2005. This £59.54 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 = \$1.50). Accordingly, Z has an ordinary loss of \$89.31 in 2006. The remaining £5 of net negative adjustment is a negative adjustment carryforward under paragraph (b)(2)(ii) of this section.

(C) *Adjusted issue price and basis—(1) January–June accrual period.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument on July 1, 2006, is £1283.89 (£1221.30 + £62.59 = £1283.89). Under paragraphs (b)(2)(iv) and (b)(3)(iii) of this section, Z's adjusted basis as of July 1, 2006, is \$1588.20 ($\$1494.31 + \93.89).

(2) *July–December accrual period.* Based on the projected payment schedule, the adjusted issue price of the debt instrument immediately before the payment at maturity is £1349.70 (£1283.89 + £65.80 accrued

interest for July–December). Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is \$1686.90 (\$1588.20 plus \$98.70 of accrued interest for July–December).

(3) *Adjustment to basis upon contingent payment.* Under paragraph (b)(7)(iii) of this section, Z's adjusted basis in the debt instrument is reduced at maturity by £243.24, the excess of Z's purchase price for the debt instrument over its adjusted issue price. For this purpose, the adjustment is translated into functional currency at the spot rate on the date the instrument was acquired (£1 = \$1). Accordingly, Z's adjusted basis in the debt instrument at maturity is \$1443.66 ($\$1686.90 - \243.24).

(D) *Amount realized.* Even though Z receives £1400 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 £5.01. Therefore, Z is treated as receiving £1344.69 (£1349.70 – £5.01) 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, £59.54 of the £1344.69 (representing the interest accrued in 2005) is translated at the rate at which it was accrued (£1 = \$1.50), resulting in an amount realized of \$89.31; £62.59 of the £1344.69 (representing the interest accrued in January–June 2006) is translated into dollars at the rate at which it was accrued (£1 = \$1.50), resulting in an amount realized of \$93.89; £65.80 of the £1344.69 (representing the interest accrued in July–December 2006) is translated into dollars at the rate at which it was accrued (£1 = \$1.50), resulting in an amount realized of \$98.70; and £1156.76 of the £1344.69 (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 \$1156.76. Z's amount realized is \$1438.66 ($\$89.31 + \$93.89 + \$98.70 + \1156.76), and Z recognizes a capital loss (before consideration of foreign currency gain or loss) of \$5 on retirement of the instrument ($\$1438.66 - \$1443.66 = -\$5$).

(E) *Foreign currency gain or loss.* Z recognizes foreign currency gain under section 988 on the instrument with respect to the entire consideration actually received at maturity, £1400. While foreign currency gain or loss ordinarily would not have arisen with respect to £50.30 of the £1400, which was initially treated as a positive adjustment in 2006, the larger negative adjustment in 2006 reduced this positive adjustment to zero. Accordingly, foreign currency gain or loss is recognized with respect to the entire £1400. Under paragraph (b)(5)(ii) of this section, however, 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, and no foreign currency gain or loss is recognized with respect to unpaid accrued interest from 2005,