

also reduced to zero by the ordinary loss. Therefore, the entire £1400 is treated as a return of principal for the purpose of determining foreign currency gain or loss, and Z recognizes a total foreign currency gain on December 31, 2001, of \$1400 [ $£1400 \times (\$2.00 - \$1.00)$ ].

(F) *Source.* Z has an ordinary loss of \$89.31, a capital loss of \$5, and a foreign currency gain of \$1400. Under paragraph (b)(6) of this section and § 1.1275-4(b)(9)(iv), the \$89.31 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 \$5 capital loss is sourced by reference to how interest income on the instrument would have been sourced. Therefore, the \$5 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 \$1400 is sourced by reference to Z's residence and is therefore from sources within the United States.

*Example 5. Sale of an instrument with a negative adjustment carryforward—(i) Facts.* On December 31, 2003, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases at original issue a debt instrument with non-currency contingencies 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 annually, and the projected payment schedule for the debt instrument provides for payments of £310 on December 31, 2005 (consisting of a noncontingent payment of £50 and a projected amount of £260) and £990 on December 31, 2006 (consisting of a noncontingent payment of £940 and a projected amount of £50). 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, 2005, is £50. On December 30, 2006, Z sells the debt instrument for £940. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 2003 .....	£1.00=\$1.00
Dec. 31, 2005 .....	£1.00=\$2.00
Dec. 30, 2006 .....	£1.00=\$2.00

  

Accrual period	Average rate (pounds to dollars)
January 1—December 31, 2004.	£1.00=\$2.00
January 1—December 31, 2005.	£1.00=\$2.00

Accrual period	Average rate (pounds to dollars)
January 1—December 31, 2006.	£1.00=\$2.00

(ii) *Treatment in 2004—(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 2004 (issue price of £1000  $\times$  10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £100 at the average exchange rate for the accrual period ( $\$2.00 \times £100 = \$200$ ). Accordingly, Z has interest income in 2004 of \$200.

(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 2004. Thus, on January 1, 2005, 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 2004. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument as of January 1, 2005, is \$1200 ( $£1000 + \$200$ ).

(iii) *Treatment in 2005—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z's accrued interest for 2005 is £110 (adjusted issue price of £1100  $\times$  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 ( $\$2.00 \times £110 = \$220$ ).

(B) *Effect of net negative adjustment.* The payment actually made on December 31, 2005, is £50, rather than the projected £310. Under paragraph (b)(2)(ii) of this section, Z has a net negative adjustment of £260 on December 31, 2005, attributable to the difference between the amount of the actual payment and the amount of the projected payment. Z's accrued interest income of £110 in 2005 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 £150 net negative adjustment as an ordinary loss to the extent of the £100 previously accrued interest in 2004. 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 ( $£1 = \$2.00$ ). Accordingly, Z has an ordinary loss of \$200 in 2005. The remaining £50 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

on January 1, 2006 is £900, i.e., the adjusted issue price of the debt instrument on January 1, 2005 (£1100), increased by the interest accrued in 2005 (£110), and decreased by the projected amount of the December 31, 2005, payment (£310). See paragraph (b)(2)(iii) of this section. Z's adjusted basis in dollars, based only on the noncontingent payments and the projected amount of the contingent payments to be received, is \$900 (determined as described below). Z's adjusted basis on January 1, 2006 is Z's adjusted basis on January 1, 2005 (£1200), increased by the functional currency amount of interest accrued in 2005 (\$220), and decreased by the amount of the payments made in 2005, based solely on the projected payment schedule, (£310). The amount of the projected payment is first attributable to the interest accrued in 2005 (£110), and then to the interest accrued in 2004 (£100), and the remaining amount to principal (£100). The interest component of the projected payment is translated into functional currency at the rates at which it was accrued, and the principal component of the projected payment is translated into functional currency at the spot rate on the date the instrument was issued. See paragraph (b)(3)(iii) of this section. Accordingly, Z's adjusted basis in the debt instrument, following the increase of adjusted basis for interest accrued in 2005 ( $£1200 + \$220 = \$1420$ ), is decreased by \$520 ( $\$220 + \$200 + \$100 = \$520$ ). Z's adjusted basis on January 1, 2006 is therefore, \$900.

(D) *Foreign currency gain or loss.* Z will recognize foreign currency gain on the receipt of the £50 payment actually received on December 31, 2005. Based on paragraph (b)(5)(iv) of this section, the £50 payment is attributable to principal since the accrued unpaid interest was completely eliminated by the net negative adjustment. The amount of foreign currency gain is determined, under paragraph (b)(5)(iii) of this section, by reference to the difference between the spot rate on the date the £50 payment was made and the spot rate on the date the debt instrument was issued. Accordingly, Z recognizes \$50 of foreign currency gain on the £50 payment. [ $(\$2.00 - \$1.00) \times £50 = \$50$ ]. Under paragraph (b)(6) of this section and § 1.988-4, Z's foreign currency gain of \$50 is sourced by reference to Z's residence and is therefore from sources within the United States.

(iv) *Treatment in 2006—(A) Determination of accrued interest.* Under paragraph (b)(2)(i) of this section, and based on the comparable yield, Z accrues £90 of interest on the debt instrument for 2004 (adjusted issue price of £900  $\times$  10 percent). Under paragraph (b)(3)(i) of this section, Z translates the £90 at the average exchange rate for the accrual period ( $\$2.00 \times £90 = \$180$ ). Accordingly, prior to taking into account the 2005 negative adjustment carryforward, Z has interest income in 2006 of \$180.

(B) *Effect of net negative adjustment.* The £50 negative adjustment carryforward from 2005 is a negative adjustment for 2006. Since there are no other positive or negative adjustments, there is a £50 negative adjustment in 2006 which reduces Z's accrued interest income by £50. Accordingly, after giving effect to the £50 negative