

adjustment carryforward, Z will accrue \$80 of interest income.  $[(£90 - £50) \times \$2.00 = \$80]$

(C) *Adjusted issue price.* Under paragraph (b)(2)(iii) of this section, the adjusted issue price of the debt instrument determined in pounds is increased by the interest accrued in 2006 (prior to taking into account the negative adjustment carryforward). Thus, on December 30, 2006, the adjusted issue price of the debt instrument is £990.

(D) *Adjusted basis.* For purposes of determining Z's dollar basis in the debt instrument, Z's \$900 adjusted basis on January 1, 2006 is increased by the accrued interest, translated at the rate at which interest was accrued for 2006. See paragraph (b)(3)(iii)(A) of this section. Note, however, that under paragraph (b)(3)(iii)(B) the amount of accrued interest which is reduced as a result of the negative adjustment carryforward, *i.e.*, £50, is treated for purposes of this section as principal, and is translated at the spot rate on the date the instrument was issued, *i.e.*, £1.00 = \$1.00. Accordingly, Z's adjusted basis in the debt instrument as of December 30, 2006, is \$1030 (\$900 + \$50 + \$80).

(E) *Amount realized.* Z's amount realized in denomination currency is £940, *i.e.*, the amount of pounds Z received on the sale of the debt instrument. Under paragraph (b)(3)(iv)(B)(1) of this section, Z's amount realized is first translated by reference to the principal component of basis (including the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section) and then the remaining amount realized, if any, is translated by reference to the accrued unpaid interest component of adjusted basis. Thus, £900 of Z's amount realized is translated by reference to the principal component of adjusted basis. The remaining £40 of Z's amount realized is treated as principal under paragraph (b)(3)(iii)(B) of this section, and is also translated by reference to the principal component of adjusted basis. Accordingly, Z's amount realized in functional currency is \$940. (No part of Z's amount realized is attributable to the interest accrued on the debt instrument.) Z realizes a loss of \$90 on the sale of the debt instrument (\$1030 basis—\$940 amount realized). Under paragraph (b)(4) of this section and § 1.1275-4(b)(8), \$80 of the loss is characterized as ordinary loss, and the remaining \$10 of loss is characterized as capital loss. Under §§ 1.988-6(b)(6) and 1.1275-4(b)(9)(iv) the \$80 ordinary loss is treated as a deduction that is definitely related to the interest income accrued on the debt instrument. Similarly, under §§ 1.988-6(b)(6) and 1.865-1(b)(2) the \$10 capital loss is also allocated to the interest income from the debt instrument.

(F) *Foreign currency gain or loss.* Z recognizes foreign currency gain with respect to the £940 he received on the sale of the debt instrument. Under paragraph (b)(5)(iv) of this section, the £940 Z received is attributable to principal (and the amount which is treated as principal under paragraph (b)(3)(iii)(B) of this section). Thus, Z recognizes foreign currency gain on December 31, 2006, of \$940.  $[(\$2.00 - \$1.00) \times £940]$ . Under paragraph (b)(6) of this section and § 1.988-4, Z's foreign currency

gain of \$940 is sourced by reference to Z's residence and is therefore from sources within the United States.

(d) *Multicurrency debt instruments—*  
(1) *In general.* Except as provided in this paragraph (d), a multicurrency debt instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be treated as an instrument described in paragraph (a)(1)(i) of this section and shall be accounted for under the rules of paragraph (b) of this section. Because payments on an instrument described in paragraph (a)(1)(ii) or (iii) of this section are denominated in, or determined by reference to, more than one currency, the issuer and holder or holders of the instrument are required to determine the denomination currency of the instrument under paragraph (d)(2) of this section before applying the rules of paragraph (b) of this section.

(2) *Determination of denomination currency.* The denomination currency of an instrument described in paragraph (a)(1)(ii) or (iii) of this section shall be the predominant currency of the instrument. The predominant currency of the instrument shall be determined by comparing the functional currency value of the noncontingent and projected payments denominated in, or determined by reference to, each currency on the issue date, discounted to present value (in each relevant currency), and translated (if necessary) into functional currency at the spot rate on the issue date. For this purpose, the applicable discount rate may be determined using any method, consistently applied, that reasonably reflects the instrument's economic substance. If a taxpayer does not determine a discount rate using such a method, the Commissioner may choose a method for determining the discount rate that does reflect the instrument's economic substance. The predominant currency is determined as of the issue date and does not change based on subsequent events (*e.g.*, changes in value of one or more currencies).

(3) *Issuer/holder consistency.* The issuer determines the denomination currency under the rules of paragraph (d)(2) of this section and provides this information to the holders of the instrument in a manner consistent with the issuer disclosure rules of § 1.1275-2(e). If the issuer does not determine the denomination currency of the instrument, or if the issuer's determination is unreasonable, the holder of the instrument must determine the denomination currency under the rules of paragraph (d)(2) of this section. A holder that determines the denomination currency itself must explicitly disclose this fact on a

statement attached to the holder's timely filed federal income tax return for the taxable year that includes the acquisition date of the instrument.

(4) *Treatment of payments in currencies other than the denomination currency.* For purposes of applying the rules of paragraph (b) of this section to debt instruments described in paragraph (a)(1)(ii) or (iii) of this section, payments not denominated in (or determined by reference to) the denomination currency shall be treated as non-currency-related contingent payments. Accordingly, if the denomination currency of the instrument is determined to be the taxpayer's functional currency, the instrument shall be accounted for under § 1.1275-4(b) rather than this section.

(e) *Instruments issued for nonpublicly traded property—*(1) *Applicability.* This paragraph (e) applies to debt instruments issued for nonpublicly traded property that would be described in paragraph (a)(1)(i), (ii), or (iii) of this section, but for the fact that such instruments are described in § 1.1275-4(c)(1) rather than § 1.1275-4(b)(1). For example, this paragraph (e) generally applies to a contingent debt instrument denominated in a nonfunctional currency that is issued for non-publicly traded property. Generally the rules of § 1.1275-4(c) apply except as set forth by the rules of this paragraph (e).

(2) *Separation into components.* An instrument described in this paragraph (e) is not accounted for using the noncontingent bond method of § 1.1275-4(b) and paragraph (b) of this section. Rather, the instrument is separated into its component payments. Each noncontingent payment or group of noncontingent payments which is denominated in a single currency shall be considered a single component treated as a separate debt instrument denominated in the currency of the payment or group of payments. Each contingent payment shall be treated separately as provided in paragraph (e)(4) of this section.

(3) *Treatment of components consisting of one or more noncontingent payments in the same currency.* The issue price of each component treated as a separate debt instrument which consists of one or more noncontingent payments is the sum of the present values of the noncontingent payments contained in the separate instrument. The present value of any noncontingent payment shall be determined under § 1.1274-2(c)(2), and the test rate shall be determined under § 1.1274-4 with respect to the currency in which each separate instrument is considered denominated. No interest payments on the separate debt instrument are