

Foreign Contingent Debt; Request for Comments Announcement 99-76

I. Summary.

The Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) intend, in the near future, to withdraw the proposed regulations under section 988 regarding contingent payment debt instruments, dual currency debt instruments and multi-currency debt instruments and are considering how new proposed regulations under section 988 should treat these types of debt instruments. This announcement is intended to apprise taxpayers of the general approach currently being considered by Treasury and the Service with respect to the taxation of contingent payment debt instruments that provide for payments denominated in or determined by reference to a nonfunctional currency (“nonfunctional currency contingent instruments”) and to request comments regarding the proper treatment of these instruments. This announcement also provides details regarding the specific rules under consideration and presents examples of the application of these rules to nonfunctional currency contingent instruments.

II. Background.

On March 17, 1992, Treasury and the Service issued proposed regulations §§ 1.988-1(a)(3),(4) and (5), regarding contingent payment debt instruments, dual currency debt instruments and multi-currency debt instruments. The proposed

regulations followed the general approach in the then proposed § 1.1275-4(g) contingent payment debt regulations (LR-189-84, 51 F.R. 12022 (1986), amended FI-189-84 56 F.R. 8308 (1991)) and bifurcated debt instruments into contingent and noncontingent components. After an instrument was bifurcated, the proposed regulations applied the rules in § 1.988-1 through -5, as appropriate, to the resulting components.

On December 16, 1994, Treasury and the Service did not adopt the bifurcation approach by withdrawing the then proposed § 1.1275-4(g) regulations. At the same time, they proposed a new set of § 1.1275-4 regulations that adopted the “noncontingent bond method.” Under the noncontingent bond method, interest is accrued on the issue price of the instrument at a rate equal to the comparable yield. Such a yield is the yield at which an issuer would issue a fixed rate debt instrument with terms and conditions similar to those of the contingent payment debt instrument. The interest on the debt instrument is original issue discount and, therefore, is taken into account as it accrues, regardless of the taxpayer’s normal method of accounting. The comparable yield is used to construct a projected payment schedule for the debt instrument, which includes a projected amount for each contingent payment.

If the actual amount of a contingent payment is greater than the projected amount, the difference is additional interest. If the actual amount of a contingent payment is less than the projected amount, the difference generally offsets current interest accruals. In some cases, the difference may result in a loss to the holder and income to the issuer. The proposed § 1.1275-4 regulations were finalized on June 14, 1996.

Treasury and the Service believe that proposed regulations §§ 1.988-1(a)(3),(4) and (5) should now be withdrawn and re-proposed since they incorporate the bifurcation approach rather than the noncontingent bond method ultimately adopted under § 1.1275-4. Treasury and the Service continue to believe that, for purposes of accounting for interest and principal on nonfunctional currency contingent instru-

ments, the principles that govern the accounting for interest and principal of functional currency contingent payment debt instruments should apply. Treasury and the Service believe that providing a consistent set of rules in this area is in the best interests of taxpayers. In addition, Treasury and the Service are concerned that, in the absence of regulations requiring the application of the principles of § 1.1275-4 to nonfunctional currency contingent instruments, taxpayers can avoid the application of these principles by denominating contingent payment debt instruments in a nonfunctional currency.

III. General Approach Under Study.

Treasury and the Service generally believe that with respect to nonfunctional currency contingent instruments issued for money or publicly traded property, regulations should apply the principles of § 1.1275-4(b) in the nonfunctional currency and provide for the translation of interest and principal into functional currency by applying principles similar to those that apply under section 988 to instruments with original issue discount. As explained further below, application of § 1.1275-4(b) principles to nonfunctional currency contingent instruments generally would require taxpayers to (i) accrue interest in the nonfunctional currency at a yield at which the issuer would issue a fixed rate debt instrument denominated in the nonfunctional currency with terms and conditions similar to those of the nonfunctional currency contingent debt instrument, (ii) translate the interest accrued from the nonfunctional currency into the functional currency (and account for foreign exchange gain or loss) under the principles of section 988, and (iii) account for gain or loss arising from non-currency contingencies consistent with the rules of § 1.1275-4(b).

IV. Description of Instruments.

Treasury and the Service have identified three classes of instruments for which guidance is needed: (1) debt instruments for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which have one or

more non-currency contingencies, (2) debt instruments for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which have no non-currency contingencies, and (3) debt instruments for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which also have one or more non-currency contingencies. Throughout this announcement these instruments will be referred to as Class One, Class Two and Class Three instruments, respectively.

A. *Class One Instruments.*

1. *In general.*

Class One instruments are debt instruments for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which have one or more non-currency contingencies. For example, with respect to a taxpayer whose functional currency is the U.S. dollar, a debt instrument issued by the taxpayer is a Class One instrument if the instrument is denominated in British pounds and provides for a payment at maturity that is contingent on the value of the stock of an unrelated corporation.

Treasury and the Service are contemplating a regulatory approach that would apply the principles of § 1.1275-4(b) to Class One instruments issued for money or publicly traded property. Under this approach, taxpayers would accrue interest under the noncontingent bond method in the nonfunctional currency. For example, an issuer of the above-described debt instrument would first determine the comparable yield of the instrument, i.e., the yield at which the issuer would issue a fixed rate instrument in British pounds with terms and conditions similar to those of the instrument actually being issued. Second, the issuer would construct a projected payment schedule applying that yield. Third, the amount of interest accrued in each taxable year would be based on the comparable yield and translated into dollars under the principles of section 988. Fourth, the issuer and holders would account for differences between the projected amount of payments and the actual amount of payments (i.e., so-called “positive adjustments” and “negative adjust-

ments”) under rules similar to those in § 1.1275-4(b). Finally, foreign currency gain or loss would be determined with respect to accrued interest and principal. A more specific explanation of this approach and two examples of the potential application of these principles are set forth below.

Treasury and the Service are concerned that, under some circumstances, an issuer may have difficulties in determining the comparable yield at which it would issue a comparable nonfunctional currency fixed rate debt instrument. These difficulties may include a lack of adequate information about the yield at which the issuer could issue a comparable fixed rate debt instrument denominated in the nonfunctional currency with terms and conditions that are similar to those of the nonfunctional currency contingent instrument. Treasury and the Service request comments regarding this and other circumstances where computation of the comparable yield would be difficult and suggestions for addressing such circumstances.

2. *Rules For Accrual and Translation.*

(a) *Accrual of interest and determination of positive and negative adjustments.*

Pursuant to the approach under study, interest on a Class One instrument is accrued each taxable year in the nonfunctional currency at the comparable yield (determined in that nonfunctional currency) and translated into functional currency at the average exchange rate or, at the taxpayer’s election, at the appropriate spot rate in accordance with the rules under § 1.988-2(b)(2)(iii)(B). A net positive adjustment, within the meaning of § 1.1275-4(b)(6), determined in the nonfunctional currency is treated as interest and translated from nonfunctional currency into the taxpayer’s functional currency at the spot rate on the date the adjustment was taken into account.

A net negative adjustment, within the meaning of § 1.1275-4(b)(6), determined in nonfunctional currency first reduces interest that otherwise would be accrued by the taxpayer during the current tax year in the nonfunctional currency. Where a net negative adjustment exceeds the interest that otherwise would be accrued by the taxpayer during the current tax year in the

nonfunctional currency, the excess is treated as an ordinary loss (if the taxpayer is a holder) or ordinary income (if the taxpayer is the issuer).

The amount treated as ordinary loss by a holder, however, is limited to the amount by which the holder’s total interest inclusions on the debt instrument (determined in nonfunctional currency prior to translation into functional currency) exceed the total amount of the holder’s net negative adjustments treated as ordinary loss on the debt instrument in prior taxable years (determined in nonfunctional currency). The amount treated as ordinary income by an issuer is limited to the amount by which the issuer’s total interest deductions on the debt instrument (determined in nonfunctional currency prior to translation into functional currency) exceed the total amount of the issuer’s net negative adjustments treated as ordinary income on the debt instrument in prior taxable years (determined in nonfunctional currency).

If the negative adjustment determined in nonfunctional currency exceeds the sum of the amounts treated as a reduction of interest income and as ordinary loss to the holder (or interest expense and ordinary income to the issuer) on the debt instrument for the taxable year, the excess is treated as a “negative adjustment carryforward” within the meaning of § 1.1275-4(b)(6). A negative adjustment carryforward arising in a year preceding the year of termination of the debt instrument is carried forward and treated as a negative adjustment denominated in nonfunctional currency in the immediately succeeding taxable year. A negative adjustment carryforward arising in the year of termination reduces (in the nonfunctional currency) the amount realized by the holder on such termination. For purposes of this reduction, both the negative adjustment carryforward and the amount realized are denominated in the nonfunctional currency. If an issuer has a negative adjustment carryforward in the year in which the debt instrument is terminated, the issuer recognizes ordinary income equal to the amount of the unutilized carryforward (computed in the nonfunctional currency and translated into functional currency at the spot rate on the date the instrument was issued).

(b) *Translation of adjustments.*

After determining the amount of a positive or negative adjustment, it may be necessary to translate such amount into functional currency. As previously stated, a net positive adjustment is translated into functional currency at the spot rate on the date the adjustment is taken into account.

One of three principles may apply to address translation issues with respect to a negative adjustment, depending on whether the net negative adjustment is allocated to interest accrued in the current taxable year, interest accrued and not paid in a prior taxable year or interest accrued and paid in a prior taxable year. With respect to a net negative adjustment that reduces interest accrued in the current year in nonfunctional currency, neither the portion of the net negative adjustment so used nor the interest reduced by such adjustment is translated into functional currency. With respect to a net negative adjustment that reduces interest accrued but not paid in a prior year, the taxpayer translates such net negative adjustment from the nonfunctional currency into its functional currency at the rate used to account for those interest accruals. For this purpose, net negative adjustments are attributable to interest accrued in the immediately preceding taxable year (to the extent the accrued interest was not paid in such year) and thereafter to interest accrued but not paid in each preceding taxable year. With respect to a net negative adjustment that reduces interest accrued and paid in a prior taxable year, the taxpayer translates such net negative adjustment at the spot rate on the issue date or purchase date, if later. Any negative adjustment carryforward is carried forward in nonfunctional currency and applied to reduce interest in subsequent years.

In a year in which the instrument is sold, exchanged or otherwise terminated, any negative adjustment carryforward not applied to interest reduces the holder's amount realized in nonfunctional currency, and no translation is required. With respect to the issuer, in a year in which the instrument is terminated any negative adjustment carryforward not applied to interest results in ordinary income equal to the amount of the carryforward not utilized. Such amount is computed in the nonfunctional currency and translated

into functional currency at the spot rate on the date the instrument was issued.

(c) *Determination of basis.*

In general, a holder computes basis adjustments in nonfunctional currency under the principles of § 1.1275-4(b)(7)(iii) and translates such adjustments into functional currency. Thus, the regulations would provide that a holder's basis in a Class One instrument is increased by the holder's accrued but unpaid interest inclusions on the debt instrument and decreased by the amount of any noncontingent payment and the projected amount of any contingent payment previously made on the debt instrument to the holder. Under this approach, these amounts, determined in nonfunctional currency, are translated under the principles of § 1.988-2(b).

(d) *Determination of amount realized.*

Under § 1.1275-4(b)(7)(iv), for purposes of determining the amount realized by a holder on the scheduled retirement of a contingent payment debt instrument, the holder is treated as receiving the projected amount of any contingent payment due at maturity. In addition, the holder's amount realized is reduced by any negative adjustment carryforward. For purposes of determining the repurchase price paid by the issuer on the scheduled retirement of a contingent payment debt instrument, the issuer is treated as paying the projected amount of any contingent payment due at maturity. Pursuant to the approach under study, these determinations would be made in the nonfunctional currency and would not take into account foreign currency gain or loss, which would be computed separately.

With respect to the holder, in the absence of a negative adjustment carryforward, the amount realized in nonfunctional currency is translated into functional currency by separating the amount realized into its component parts. Consistent with the principles of § 1.988-2(b)(7), the portion of the amount realized equal to accrued but unpaid interest is translated into functional currency at the same rate used to translate those accruals in the relevant years. The remainder of the projected payment is translated into functional currency at the same rate used

to translate principal in the year of issuance or purchase. (Foreign currency gain or loss is computed separately as set forth below.) A negative adjustment carryforward is applied and translated into functional currency under the rules set forth above.

(e) *Determination of foreign currency gain or loss.*

Foreign currency gain or loss is determined on a Class One instrument with respect to principal and interest based on the comparable yield and projected payment schedule under the principles of § 1.988-2(b). Except with respect to a positive adjustment described in § 1.1275-4 (b)(9)(ii)(A), no foreign currency gain or loss is computed with respect to positive or negative adjustments.

(f) *Source rules.*

Any contingent gain characterized as interest is sourced under rules applicable to interest (*i.e.*, sections 861(a)(1) and 862(a)(1)). Under Temp. Reg. § 1.865-1T(b)(2), losses by a holder from a contingent payment debt instrument is generally sourced by reference to § 1.1275-4(b)(9)(iv). Under § 1.1275-4(b)(9)(iv), a holder's deductions or loss related to a contingent payment debt instrument that are treated as ordinary losses are treated as deductions that are definitely related to the class of gross income to which income from such debt instrument belongs. Treasury and the Service believe that the same rule should apply for sourcing of losses related to Class One instruments. Accordingly, a holder's ordinary losses resulting from negative adjustments with respect to a Class One instrument would be given the same source as the interest income from the instrument. Similarly, Treasury and the Service believe that deductions or losses related to a Class One instrument that the holder treats as capital losses should, consistent with the general principles of § 1.865-1T(b)(2), be sourced based on the residence of the holder.

(g) *Netting.*

Treasury and the Service recognize that there are different character and source rules which relate to market gain or loss and currency gain or loss on a Class One

instrument and are studying the extent to which netting of such gains or losses should be permitted. For illustration purposes, in Example 2 below, the amounts related to currency gain or loss and market gain or loss are computed separately. Comments are requested regarding the extent to which netting should be permitted.

3. Examples.

The following examples are intended to illustrate the principles outlined above. In each example, assume that the instrument described is a debt instrument for federal income tax purposes. No inference is intended, however, as to whether the instrument is a debt instrument for federal income tax purposes.

Example 1.

On December 31, 1999, Z, a calendar year U.S. resident taxpayer whose functional currency is the U.S. dollar, purchases, at original issue, a zero-coupon debt instrument with a non-currency contingency for £1,000. The debt instrument was issued by a foreign corporation. 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, as constructed under the principles of § 1.1275-4(b), provides for a single payment of £1210 on December 31, 2001 (consisting of a noncontingent payment of £975 and a projected payment of £235).

The debt instrument is a capital asset in the hands of Z. The payment actually made on December 31, 2001, is £1300. The relevant pound/dollar spot rates over the term of the instrument are as follows:

Date	Spot rate (pounds to dollars)
Dec. 31, 1999	£1.00=\$1.00
Dec. 31, 2000	£1.00=\$1.10
Dec. 31, 2001	£1.00=\$1.20
Accrual period	Average rate (pounds to dollars)
2000	£1.00=\$1.05
2001	£1.00=\$1.15

(i) *Treatment in 2000.* (A) *Determination of accrued interest.* Under the prin-

ciples of section 988 and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2000 (issue price of £1,000 × 10 percent). Z translates the £100 at the average exchange rate for the year ($1.05 \times £100 = \$105$). Accordingly, Z has interest income in 2000 of \$105, which is foreign source under section 862(a)(1).

(B) *Adjustments to issue price and basis relating to accrued interest.* 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 accrued interest. Thus, on January 1, 2001, 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 is increased by the £100 translated at the rate at which interest was accrued for 2000. Accordingly, Z's adjusted basis in the instrument in dollars is \$1105 as of January 1, 2001.

(ii) *Treatment in 2001.* (A) *Determination of accrued interest.* Based on the comparable yield, Z's accrued interest for 2001 is £110 (adjusted issue price of £1100 × 10 percent). For purposes of computing Z's interest inclusions in dollars, the £110 of accrued interest is translated at the average exchange rate for 2001 ($1.15 \times £110 = \$126.50$).

(B) *Effect of net positive adjustment.* The payment actually made on December 31, 2001, is £1300, rather than the projected £1210. Under the principles of § 1.1275-4(b)(6)(i), Z has a net positive adjustment of £90 on December 31, 2001, attributable to the difference between the amount of the actual payment and the amount of the projected payment. The £90 net positive adjustment is treated as interest income and translated into dollars at the spot rate on the date the payment is received ($1.2 \times £90 = \$108$). Accordingly, Z has a net positive adjustment of \$108 resulting in a total interest inclusion for 2001 of \$234.50 ($\$126.50 + \108).

(C) *Adjustments to issue price and basis relating to accrued interest.* 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 2001). Z's adjusted basis, in dollars, is \$1231.50 ($\1105 plus $\$126.50$ of accrued interest for 2001).

(D) *Amount realized.*

(i) Even though Z receives £1300 at maturity, for purposes of determining the amount realized, Z is treated as receiving the projected amount of the contingent payment on December 31, 2001. Therefore, Z is treated as receiving £1210 on December 31, 2001.

(ii) For purposes of determining the amount realized (other than for purposes of determining foreign exchange gain or loss as calculated below) in dollars, £100 (representing the interest accrued in 2000) is translated into dollars at the rate at which it was accrued ($£1 = \$1.05$), resulting in an amount realized of \$105; £110 of the £1210 (representing the interest accrued in 2001) is translated into dollars at the rate at which such payment was accrued ($£1 = \$1.15$), resulting in an amount realized of \$126.50; and £1000 (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 \$1000. Accordingly, Z's total amount realized is \$1231.50, the same as its basis, and Z recognizes no gain or loss (prior to consideration of foreign exchange gain or loss) on the retirement of the instrument.

(E) *Foreign exchange gain or loss.* Z realizes foreign exchange gain under section 988 on the instrument as a result of the difference in the exchange rate at which interest was accrued on the instrument and the spot rate on the date the instrument matures. With respect to interest accrued in 2000, this foreign exchange gain equals $£100 \times (\$1.2 - \$1.05) = \$15.00$ (i.e., the amount of the interest payment multiplied by the difference between the exchange rate on the date the interest payment was received ($£1 = \$1.2$) and the exchange rate at which interest was accrued during 2001 ($£1 = \$1.05$)). With respect to interest accrued in 2001, this foreign exchange gain equals $£110 \times (\$1.2 - \$1.15) = \$5.50$. Z also has foreign exchange gain on the repayment of the principal of the debt instrument. Such foreign exchange gain equals $£1000 \times (\$1.2 - \$1.0) = \$200$ (i.e., the amount of principal received multiplied by the difference between the spot rate on the date the debt instrument matures and the spot rate on the date Z purchased the instrument). Thus, Z recognizes a total foreign

exchange gain on December 31, 2001, of \$220.50

(F) *Source.* In 2001, Z has interest income of \$234.50 (attributable to £110 of accrued interest and the £90 net positive adjustment) which under section 862(a)(1) is sourced by reference to the residence of the payor and is therefore foreign source. Z also has foreign exchange gain of \$220.50, which under § 1.988-4 is sourced by reference to Z's residence and is therefore U.S. source.

Example 2.

Assume the same facts as in Example 1 except that at maturity Z receives £975 instead of £1300.

(i) *Treatment in 2000.* (A) *Determination of accrued interest.* Under the principles of section 988 and based on the comparable yield, Z accrues £100 of interest on the debt instrument for 2000 (issue price of £1,000 x 10 percent). Z translates the £100 at the average exchange rate for the year ($1.05 \times £100 = \$105$). Accordingly, Z has interest income in 2000 of \$105, which is foreign source under section 862(a)(1).

(B) *Adjustments to issue price and basis relating to accrued interest.* 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 accrued interest. Thus, on January 1, 2001, 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 is increased by the £100 translated at the rate at which interest was accrued for 2000. Accordingly, Z's adjusted basis in the instrument in dollars is \$1105 as of January 1, 2001.

(ii) *Treatment in 2001.* (A) *Determination of accrued interest.* Based on the comparable yield, Z's total daily portions of accrued interest are £110 for 2001 (adjusted issue price of £1100 x 10 percent). Despite the effect of the net negative adjustment set forth in (ii)(B) below, for purposes of computing Z's adjusted basis and amount realized the £110 of accrued interest is translated into dollars at the average spot rate at which such interest was accrued (£1 = \$1.15) to equal \$126.50.

(B) *Effect of net negative adjustment on accrued interest.* Z has a net negative adjustment of £235 on December 31, 2001,

attributable to the difference between the amount of the actual payment (£0) and the amount of the projected payment (£235). Applying the principles of § 1.1275-4, Z's accrued interest income of £110 in 2001 is reduced in pounds by the net negative adjustment to zero.

Further, because Z previously accrued interest of £100 in the year 2000, Z treats £100 of the remaining £125 net negative adjustment as an ordinary loss. This ordinary loss is attributable to interest accrued but not paid in the preceding year. Therefore, Z translates the loss into dollars at the average rate for such year (£1 = \$1.05). Accordingly, Z has an ordinary loss of \$105. (See paragraph (ii) (D) and (E) below for the treatment of the remaining £25 of net negative adjustment).

(C) *Adjustments to issue price and basis relating to accrued interest.* 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 2001). Z's adjusted basis in dollars is \$1231.50 (\$1105, representing Z's adjusted basis at the end of 2000 (calculated in (i)(B) above), plus \$126.50 accrued interest for 2001).

(D) *Determination of amount realized.*

(i) *In pounds.* Even though Z receives only £975 at maturity, for purposes of determining the amount realized by Z on retirement of the debt instrument, Z is treated as receiving the projected amount of the contingent payment (in pounds) on December 31, 2001, reduced by the amount of Z's negative adjustment carry-forward of £25. Therefore, Z is treated as receiving £1185 (£1210 - £25) on December 31, 2001.

(ii) *In dollars.* Z translates its amount realized into dollars and computes its gain or loss on the instrument (other than foreign exchange gain or loss) pursuant to the payment ordering rules of § 1.988-2(b)(7). Pursuant to these rules, of the £1185 amount realized, £100 represents interest accrued in 2000, £110 represents interest accrued in 2001, and £975 represents a return of principal.

Of the amount realized of £1185, £100 is translated based on the rate interest was accrued in 2000 (£1 = \$1.05) to equal \$105. Another £110 is translated based on the rate interest was accrued in 2001

(£1 = \$1.15) to equal \$126.50. The remaining £975 is translated into dollars at the spot rate on the date the instrument was purchased (£1 = \$1) to equal \$975.

Accordingly, Z's amount realized (without taking into account foreign exchange gain or loss) is \$1206.50 (\$105 + \$126.50 + \$975), and Z computes a capital loss of \$25 on the retirement of the instrument ($\$1206.50 - \$1231.50 = \$25$).

(E) *Foreign exchange gain or loss.* Z computes a foreign exchange gain on the repayment of principal as follows: £975 x (1.2 - 1.0) (i.e., the amount of the principal payment multiplied by the difference between the spot rate on the date of payment (£1 = \$1.2) and the spot rate on the date the instrument was purchased (£1 = \$1.0)). Accordingly, Z's foreign exchange gain is \$195. This foreign exchange gain is characterized as ordinary income. (Because the interest accrued in 2000 and 2001, as well as £25 of principal, was not actually received, no foreign exchange gain or loss is realized with respect to such amounts.)

(F) *Sourcing.*

(i) *Losses.* On December 31, 2001, Z has an ordinary loss of \$105 (attributable to £100 of Z's previous interest inclusions) and a capital loss of \$25. Under the principles of § 1.1275-4(b)(9)(iv), the \$105 ordinary loss is allocated to the foreign source passive income category under section 904(d) and the regulations thereunder. Under the principles of § 1.865-1T(b)(2), the \$25 capital loss is sourced based on Z's residence and, accordingly, is U.S. source.

(ii) *Foreign currency gain.* Z's foreign currency gain of \$195 is sourced under section 988(a)(3) by reference to the residence of Z. Thus, Z's foreign currency gain is U.S. source.

(G) *Netting.* On December 31, 2001, Z has an ordinary loss of \$105 (attributable to £100 of Z's previous interest inclusions as computed in paragraph (B)), a capital loss of \$25 (attributable to the net negative adjustment on the instrument as computed in paragraph (D)) and an overall foreign exchange gain on the instrument of \$195 (as computed in paragraph (E)). Treasury and the IRS request comments concerning whether such amounts should be treated separately by taxpayers or whether netting of these gains and

losses for purposes of character and source should be required. Regulations could provide, for example, that taxpayers must net capital losses (resulting from net negative adjustments) against foreign exchange gains to avoid a character mismatch between gains and losses from a single instrument. This approach is similar to the one adopted by § 1.988-2(b)(8) with respect to the disposition of debt instruments.

B. *Class Two Instruments.*

Class Two instruments consist of contingent payment debt instruments for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which have no non-currency contingencies. For example, this class would include both a debt instrument that pays a fixed euro interest rate and principal in British pounds and a debt instrument that pays a fixed dollar interest rate and principal in Japanese Yen.

Treasury and the Service are studying an approach under which the proper accounting for a Class Two instrument issued for money or publicly traded property would require a determination of the comparable yield in a single currency and accrual of interest at such yield under the principles of § 1.1275-4(b). Under this approach, the regulations would require that the comparable yield on the debt instrument be determined in the debt instrument's predominant currency. In general, Treasury and the Service expect that the debt instrument's predominant currency would be determined by comparing the functional currency value of the payments denominated in (or determined by reference to) each currency on the issue date, appropriately discounted to present value (in each relevant currency) and translated at the spot rate on such date. Accordingly, in the case of a debt instrument issued for euros that pays a fixed euro interest rate and principal in British pounds, the issuer would determine the predominant currency on the issue date and then apply the principles of § 1.1275-4(b) to determine the comparable yield and projected payment schedule in that currency. For this purpose, payments not denominated in (or

determined by reference to) the predominant currency would be treated in the same manner as non-currency contingencies in a Class One instrument.

Where a significant portion of the payments (as determined on a present value basis as of the issue date) with respect to a Class Two instrument is made in the functional currency of the taxpayer, the Treasury and the Service are studying whether the regulations should treat the functional currency as the instrument's predominant currency. In such case, the comparable yield and projected payment schedule would be determined by applying the principles of § 1.1275-4(b) in the functional currency of the taxpayer. Payments denominated in the nonfunctional currency would be treated in the same manner as non-currency contingencies under § 1.1275-4(b). As a result, no section 988 foreign exchange gain or loss would be recognized with respect to a Class Two instrument for which a significant portion of payments is denominated in, or determined by reference to, the taxpayer's functional currency.

C. *Class Three Instruments.*

Class Three instruments are debt instruments for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which also have one or more non-currency contingencies. Consistent with the treatment of Class One and Class Two debt instruments, Treasury and the Service are considering an approach that would require taxpayers to determine the comparable yield of a Class Three instrument issued for money or publicly traded property by applying the principles of § 1.1275-4(b) in a single currency (which would be determined under the same methodology used for determining the predominant currency of a Class Two instrument). The principles of § 1.1275-4(b) would then be applied with respect to all of the contingent payments on the Class Three instrument (i.e., contingent payments denominated in the predominant currency and all payments denominated in, or determined by reference to, any currency other than the predominant currency).

V. *Debt Issued for Non-publicly Traded Property.*

Section 1.1275-4(c) provides rules for the treatment of contingent payment debt instruments issued for non-publicly traded property. Treasury and the Service are considering an approach that would apply the principles of § 1.1275-4(c) in the relevant nonfunctional currency and would require the translation of the resulting interest and principal components into the taxpayer's functional currency under the principles of section 988 and the regulations thereunder.

VI. *Anti-abuse Rules.*

Treasury and the Service recognize that a contingent payment debt instrument can be unbundled. These unbundled components, together with the underlying contingent payment debt instrument may lead to timing, character and source distortions. Treasury and the Service request comments on how to draft a narrowly tailored rule that would provide taxpayers with flexibility and certainty with respect to nonfunctional currency contingent instruments while preventing abuse.

VII. *Comments.*

Treasury and Service request comments on the matters discussed in this announcement November 1, 1999. Written comments may be submitted to the Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attention: CC:DOM:CORP:R (Announcement 99-76), Room 5226, Washington DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Announcement 99-76), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington DC.

For further information regarding this announcement, contact Howard Wiener of the Office of Associate Chief Counsel (International) at 202-874-4160 (not a toll-free call).