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currency is hyperinflationary for purposes of section 988. Accordingly, generally accepted accounting principles may not apply to alter the base period for purposes of this paragraph (f).

(2) *Effective date.* Paragraph (f)(1) of this section shall apply to transactions entered into after February 14, 2000.

(g) *Fair market value.* The fair market value of an item shall, where relevant, reflect an appropriate premium or discount for the time value of money (*e.g.*, the fair market value of a forward contract to buy or sell nonfunctional currency shall reflect the present value of the difference between the units of nonfunctional currency times the market forward rate at the time of valuation and the units of nonfunctional currency times the forward rate set forth in the contract). However, if consistent with the taxpayer's method of financial accounting (and consistently applied from year to year), the preceding sentence shall not apply to a financial instrument that matures within one year from the date of issuance or acquisition. Unless otherwise provided, the fair market value given in any example used in §§ 1.988–1 through 1.988–5 is deemed to reflect appropriately the time value of money. If the use of inconsistent sources of forward or other market rate quotations results in the distortion of income, the District Director or the Assistant Commissioner (International) may determine the appropriate rate.

(h) *Interaction with sections 1092 and 1256.* Unless otherwise provided, it is assumed for purposes of §§ 1.988–1 through 1.988–5 that any contract used in any example is not a section 1256 contract and is not part of a straddle as defined in section 1092. No inference is intended regarding the application of section 1092 or 1256 unless expressly stated.

(i) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section. Generally, the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years beginning one year after the first day of the first taxable year following December 7, 2016. If pursuant to § 1.987–11(b) a taxpayer applies §§ 1.987–1 through 1.987–11 beginning in a taxable year prior to the earliest taxable year described in § 1.987–11(a), then the revisions to paragraphs (a)(3), (a)(4), and (a)(10)(ii) of this section shall apply to taxable years of the taxpayer beginning on or after the first day of such prior taxable year.

[T.D. 8400, 57 FR 9178, Mar. 17, 1992, as amended by T.D. 8914, 66 FR 280, Jan. 3, 2001; T.D. 9794, 81 FR 88850, Dec. 8, 2016; T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§ 1.988–1T Certain definitions and special rules (temporary).

(a)(1) through (a)(2) [Reserved]. For further guidance, see § 1.988–1(a)(1) through (2).

(3) *Specified owner functional currency transactions of a section 987 QBU not treated as section 988 transactions.* Specified owner functional currency transactions, as defined in § 1.987–3T(b)(4)(ii), held by a section 987 QBU are not treated as section 988 transactions. Thus, no currency gain or loss shall be recognized by a section 987 QBU under section 988 with respect to such transactions.

(4) through (i) [Reserved]. For further guidance, see § 1.988–1(a)(4) through (i).

(j) *Effective/applicability date.* This section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under § 1.987–11(b), then this section applies to taxable years to which §§ 1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§ 1.988–2 Recognition and computation of exchange gain or loss.

(a) *Disposition of nonfunctional currency*—(1) *Recognition of exchange gain or loss*—(i) *In general.* Except as otherwise provided in this section, § 1.988–1(a)(7)(ii), and § 1.988–5, the recognition of exchange gain or loss upon the sale

or other disposition of nonfunctional currency shall be governed by the recognition provisions of the Internal Revenue Code which apply to the sale or disposition of property (*e.g.*, section 1001 or, to the extent provided in regulations, section 1092). The disposition of nonfunctional currency in settlement of a forward contract, futures contract, option contract, or similar financial instrument is considered to be a sale or disposition of the nonfunctional currency for purposes of the preceding sentence.

(ii) *Clarification of section 1031.* An amount of one nonfunctional currency is not ''property of like kind'' with respect to an amount of a different nonfunctional currency.

(iii) *Coordination with section 988(c)(1)(C)(ii).* No exchange gain or loss is recognized with respect to the following transactions—

(A) An exchange of units of nonfunctional currency for different units of the same nonfunctional currency;

(B) The deposit of nonfunctional currency in a demand or time deposit or similar instrument (including a certificate of deposit) issued by a bank or other financial institution if such instrument is denominated in such currency;

(C) The withdrawal of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution if such instrument is denominated in such currency;

(D) The receipt of nonfunctional currency from a bank or other financial institution from which the taxpayer purchased a certificate of deposit or similar instrument denominated in such currency by reason of the maturing or other termination of such instrument; and

(E) The transfer of nonfunctional currency from a demand or time deposit or similar instrument issued by a bank or other financial institution to another demand or time deposit or similar instrument denominated in the same nonfunctional currency issued by a bank or other financial institution.

The taxpayer's basis in the units of nonfunctional currency or other property received in the transaction shall be the adjusted basis of the units of nonfunctional currency or other property transferred. See paragraph (b) of this section with respect to the timing of interest income or expense and the determination of exchange gain or loss thereon.

(iv) *Example.* The following example illustrates the provisions of paragraph (a)(1)(iii) of this section.

Example. X is a corporation on the accrual method of accounting with the U.S. dollar as its functional currency. On January 1, 1989, X acquires 1,500 British pounds (£) for $2,250 (£1 = $1.50). On January 3, 1989, when the spot rate is £1 = $1.49, X deposits the £1,500 with a British financial institution in a non-interest bearing demand account. On February 1, 1989, when the spot rate is £1 = $1.45, X withdraws the £1,500. On February 5, 1989, when the spot rate is £1 = $1.42, X purchases inventory in the amount of £1,500. Pursuant to paragraph (a)(1)(iii) of this section, no exchange loss is realized until February 5, 1989, when X disposes of the £1,500 for inventory. At that time, X realizes exchange loss in the amount of $120 computed under paragraph (a)(2) of this section. The loss is not an adjustment to the cost of the inventory.

(2) *Computation of gain or loss*—(i) *In general.* Exchange gain realized from the sale or other disposition of nonfunctional currency shall be the excess of the amount realized over the adjusted basis of such currency, and exchange loss realized shall be the excess of the adjusted basis of such currency over the amount realized.

(ii) *Amount realized*—(A) *In general.* The amount realized from the disposition of nonfunctional currency shall be determined under section 1001(b). A taxpayer that uses a spot rate convention under §1.988–1(d)(3) to determine exchange gain or loss with respect to a payable shall determine the amount realized upon the disposition of nonfunctional currency paid in satisfaction of the payable in a manner consistent with such convention.

(B) *Exchange of nonfunctional currency for property.* For purpose of paragraph (a)(2) of this section, the exchange of nonfunctional currency for property (other than nonfunctional currency) shall be treated as—

(*1*) An exchange of the units of nonfunctional currency for units of functional currency at the spot rate on the date of the exchange, and

(*2*) The purchase or sale of the property for such units of functional currency.

(C) *Example.* The following example illustrates the provisions of paragraph (a)(2)(ii)(B) of this section.

Example. G is a U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1989, G enters into a contract to purchase a paper manufacturing machine for 10,000,000 British pounds (£) for delivery on January 1, 1991. On January 1, 1991, when G exchanges £10,000,000 (which G purchased for $12,000,000) for the machine, the fair market value of the machine is £17,000,000. On January 1, 1991, the spot exchange rate is £1 = $1.50. Under paragraph (a)(2)(ii)(B) of this section, the transaction is treated as an exchange of £10,000,000 for $15,000,000 and the purchase of the machine for $15,000,000. Accordingly, in computing G's exchange gain of $3,000,000 on the disposition of the £10,000,000, the amount realized is $15,000,000. G's basis in the machine is $15,000,000. No gain is recognized on the bargain purchase of the machine.

(iii) *Adjusted basis*—(A) *In general.* Except as provided in paragraph (a)(2)(iii)(B) of this section, the adjusted basis of nonfunctional currency is determined under the applicable provisions of the Internal Revenue Code (*e.g.*, sections 1011 through 1023). A taxpayer that uses a spot rate convention under §1.988–1 (d)(3) to determine exchange gain or loss with respect to a receivable shall determine the basis of nonfunctional currency received in satisfaction of such receivable in a manner consistent with such convention.

(B) *Determination of the basis of nonfunctional currency withdrawn from an account with a bank or other financial institution—(1) In general.* The basis of nonfunctional currency withdrawn from an account with a bank or other financial institution shall be determined under any reasonable method that is consistently applied from year to year by the taxpayer to all accounts denominated in a nonfunctional currency. For example, a taxpayer may use a first in first out method, a last in first out method, a pro rata method (as illustrated in the example below), or any other reasonable method that is consistently applied. However, a method that consistently results in units of nonfunctional currency with the highest basis being withdrawn first shall not be considered reasonable.

(*2*) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iii)(B).

Example. (i) X, a cash basis individual with the dollar as his functional currency, opens a demand account with a Swiss bank. Assume expenses associated with the demand account are deductible under section 212. The following chart indicates Swiss franc deposits to the account, Swiss franc interest credited to the account, the dollar basis of each deposit, and the determination of the aggregate dollar basis of all Swiss francs in the account. Assume that the taxpayer has properly translated all the amounts specified in the chart and that all transactions are subject to section 988.

Date	Swiss francs deposited	Interest received	U.S. dollar basis	Aggregate U.S. dollar basis
1/01/89	1000 Sf		$500	$500
3/31/89		50 Sf	25	525
6/30/89		50 Sf	24	549
9/30/89		50 Sf	25	574
12/31/89		50 Sf	26	600

(ii) On January 1, 1990, X withdraws 500 Swiss francs from the account. X may determine his basis in the Swiss francs by multiplying the aggregate U.S. dollar basis of Swiss francs in the account by a fraction the numerator of which is the number of Swiss francs withdrawn from the account and the denominator is the total number of Swiss francs in the account. Under this method, X's basis in the 500 Swiss francs is $250 computed as follows:

$$\frac{500\ \text{Sf}}{1200\ \text{Sf}} \times \$600 = \$250$$

(iii) X's basis in the Swiss francs remaining in the account is $350 ($600 − $250). X must use this method consistently from year to year with respect to withdrawals of nonfunctional currency from all of X's accounts.

(iv) Purchase and sale of stock or securities traded on an established securities market by cash basis taxpayer—

(A) *Amount realized.* If stock or securities traded on an established securities market are sold by a cash basis taxpayer for nonfunctional currency, the amount realized with respect to the stock or securities (as determined on the trade date) shall be computed by translating the units of nonfunctional currency received into functional currency at the spot rate on the settlement date of the sale. This rule applies notwithstanding that the stock or securities are treated as disposed of on a date other than the settlement date under another section of the Code. See section 453(k).

(B) *Basis.* If stock or securities traded on an established securities market are purchased by a cash basis taxpayer for nonfunctional currency, the basis of the stock or securities shall be determined by translating the units of nonfunctional currency paid into functional currency at the spot rate on the settlement date of the purchase.

(C) *Example.* The following example illustrates the provisions of this paragraph (a)(2)(iv).

Example. On November 1, 1989 (the trade date), X, a calendar year cash basis U.S. individual, purchases stock for £100 for settlement on November 5, 1989. On November 1, 1989, the spot value of the £100 is $140. On November 5, 1989, X purchases £100 for $141 which X uses to pay for the stock. X's basis in the stock is $141. On December 30, 1990 (the trade date), X sells the stock for £110 for settlement on January 5, 1991. On December 30, 1990, the spot value of £110 is $165. On January 5, 1991, X transfers the stock and receives £110 which, translated at the spot rate, equal $166. Under section 453(k), the stock is considered disposed of on December 30, 1990. The amount realized with respect to such disposition is the value of the £110 on January 5, 1991 ($166). Accordingly, X's gain realized on December 30, 1990, from the disposition of the stock is $25 ($166 amount realized less $141 basis). X's basis in the £110 received from the sale of the stock is $166.

(v) *Purchase and sale of stock or securities traded on an established securities market by accrual basis taxpayer.* For taxable years beginning after March 17, 1992, an accrual basis taxpayer may elect to apply the rules of paragraph (a)(2)(iv) of this section. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently from year to year and cannot be changed without the consent of the Commissioner.

(b) *Translation of interest income or expense and determination of exchange gain or loss with respect to debt instruments—*(1) *Translation of interest income received with respect to a nonfunctional currency demand account.* Interest income received with respect to a demand account with a bank or other financial institution which is denominated in (or the payments of which are determined by reference to) a nonfunctional currency shall be translated into functional currency at the spot rate on the date received or accrued or pursuant to any reasonable spot rate convention consistently applied by the taxpayer to all taxable years and to all accounts denominated in nonfunctional currency in the same financial institution. For example, a taxpayer may translate interest income received with respect to a demand account on the last day of each month of the taxable year, on the last day of each quarter of the taxable year, on the last day of each half of the taxable year, or on the last day of the taxable year. No exchange gain or loss is realized upon the receipt or accrual of interest income with respect to a demand account subject to this paragraph (b)(1).

(2) *Translation of nonfunctional currency interest income or expense received or paid with respect to a debt instrument described in § 1.988–1(a)(1)(ii) and (2)(i)—*(i) *Scope—*(A) *In general.* Paragraph (b) of this section only applies to debt instruments described in § 1.988–1(a)(1)(ii) and (2)(i) where all payments are denominated in, or determined with reference to, a single nonfunctional currency. Except as provided in paragraph (b)(2)(i)(B) of this section, this paragraph (b) shall not apply to contingent payment debt instruments.

(B) *Nonfunctional currency contingent payment debt instruments—*(*1*) *Operative rules.* See § 1.988–6 for rules applicable to contingent payment debt instruments for which one or more payments are denominated in, or determined by reference to, a nonfunctional currency.

(*2*) *Certain instruments are not contingent payment debt instruments.* For purposes of sections 163(e) and 1271 through 1275 and the regulations thereunder, a debt instrument does not provide for contingent payments merely because the instrument is denominated

in, or all payments of which are determined with reference to, a single nonfunctional currency. See §1.988–6 for the treatment of nonfunctional currency contingent payment debt instruments.

(ii) *Determination and translation of interest income or expense*—(A) *In general.* Interest income or expense on a debt instrument described in paragraph (b)(2)(i) of this section (including original issue discount determined in accordance with sections 1271 through 1275 and 163(e) as adjusted for acquisition premium under section 1272(a)(7), and acquisition discount determined in accordance with sections 1281 through 1283) shall be determined in units of nonfunctional currency and translated into functional currency as provided in paragraphs (b)(2)(ii)(B) and (C) of this section. For purposes of sections 483, 1273(b)(5) and 1274, the nonfunctional currency in which an instrument is denominated (or by reference to which payments are determined) shall be considered money.

(B) *Translation of interest income or expense that is not required to be accrued prior to receipt or payment.* With respect to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense received or paid that is not required to be accrued by the taxpayer prior to receipt or payment shall be translated at the spot rate on the date of receipt or payment. No exchange gain or loss is realized with respect to the receipt or payment of such interest income or expense (other than the exchange gain or loss that might be realized under paragraph (a) of this section upon the disposition of the nonfunctional currency so received or paid).

(C) *Translation of interest income or expense that is required to be accrued prior to receipt or payment.* With respect to an instrument described in paragraph (b)(2)(i) of this section, interest income or expense that is required to be accrued prior to receipt or payment (*e.g.*, under section 1272, 1281 or 163(e) or because the taxpayer uses an accrual method of accounting) shall be translated at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the interest accrual period or, with respect to an interest accrual period that spans two taxable years, at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the partial period within the taxable year. See paragraphs (b)(3) and (4) of this section for the determination of exchange gain or loss on the receipt or payment of accrued interest income or expense.

(iii) *Determination of average rate or other accrual convention*—(A) *In general.* For purposes of this paragraph (b), the average rate for an accrual period (or partial period) shall be a simple average of the spot exchange rates for each business day of such period or other average exchange rate for the period reasonably derived and consistently applied by the taxpayer.

(B) *Election to use spot accrual convention.* For taxable years beginning after March 17, 1992, a taxpayer may elect to translate interest income and expense at the spot rate on the last day of the interest accrual period (and in the case of a partial accrual period, the spot rate on the last day of the taxable year). If the last day of the interest accrual period is within five business days of the date of receipt or payment, the taxpayer may translate interest income or expense at the spot rate on the date of receipt or payment. The election shall be made by filing a statement with the taxpayer's first return in which the election is effective clearly indicating that the election has been made. A method so elected must be applied consistently to all debt instruments from year to year and cannot be changed without the consent of the Commissioner.

(3) *Exchange gain or loss recognized by the holder with respect to accrued interest income.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest income on the date such accrued interest income is received or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest income shall be recognized in accordance with the

applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest income is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest income received with respect to such accrual period (as determined under the ordering rules of paragraph (b)(7) of this section) into functional currency at the spot rate on the date the interest income is received or the instrument is disposed of (or deemed disposed of), and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest income accrued with respect to such income received at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for the accrual period.

(4) *Exchange gain or loss recognized by the obligor with respect to accrued interest expense.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to accrued interest expense on the date such accrued interest expense is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to accrued interest expense shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized with respect to accrued interest expense is determined for each accrual period by—

(i) Translating the units of nonfunctional currency interest expense accrued with respect to the amount of interest paid into functional currency at the average rate (or other rate specified in paragraph (b)(2)(iii)(B) of this section) for such accrual period; and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency interest paid (or, if the obligation to make payments is extinguished or transferred, the units accrued) with respect to such accrual period (as determined under the ordering rules in paragraph (b)(7) of this section) into functional currency at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(5) *Exchange gain or loss recognized by the holder of a debt instrument with respect to principal.* The holder of a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is received from the obligor or the instrument is disposed of (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the holder's purchase price in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the holder acquired the instrument in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to the holder shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal amount shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the holder with respect to principal is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date payment is received or the instrument is disposed of (or deemed disposed of); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date

the holder (or a transferor from whom the nonfunctional principal amount is carried over) acquired the instrument (is deemed to acquire the instrument).

(6) *Exchange gain or loss recognized by the obligor of a debt instrument with respect to principal.* The obligor under a debt instrument described in paragraph (b)(2)(i) of this section shall realize exchange gain or loss with respect to the principal amount of such instrument on the date principal (determined under the ordering rules of paragraph (b)(7) of this section) is paid or the obligation to make payments is transferred or extinguished (including a deemed disposition under section 1001 that results from a material change in terms of the instrument). For purposes of computing exchange gain or loss, the principal amount of a debt instrument is the amount received by the obligor for the debt instrument in units of nonfunctional currency. See paragraph (b)(10) of this section for rules regarding the amortization of that part of the principal amount that represents bond premium and the computation of exchange gain or loss thereon. If, however, the obligor became the obligor in a transaction in which exchange gain or loss was realized but not recognized by the transferor, the nonfunctional currency principal amount of the instrument with respect to such obligor shall be the same as that of the transferor. Except as otherwise provided in this paragraph (b) (*e.g.*, paragraph (b)(8) of this section), exchange gain or loss realized with respect to such principal shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. The amount of exchange gain or loss so realized by the obligor is determined by—

(i) Translating the units of nonfunctional currency principal at the spot rate on the date the obligor (or a transferor from whom the principal amount is carried over) became the obligor (or is deemed to have become the obligor); and

(ii) Subtracting from such amount the amount computed by translating the units of nonfunctional currency principal at the spot rate on the date payment is made or the obligation is transferred or extinguished (or deemed extinguished).

(7) *Payment ordering rules*—(i) *Debt instruments subject to the rules of sections 163(e), or 1271 through 1288.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is subject to the rules of sections 163(e), or 1272 through 1288, units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument shall be treated first as a receipt or payment of periodic interest under the principles of section 1273 and the regulations thereunder, second as a receipt or payment of original issue discount to the extent accrued as of the date of the receipt or payment, and finally as a receipt or payment of principal. Units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) treated as a receipt or payment of original issue discount under the preceding sentence are attributed to the earliest accrual period in which original issue discount has accrued and to which prior receipts or payments have not been attributed. No portion thereof shall be treated as prepaid interest. These rules are illustrated by *Example 10* of paragraph (b)(9) of this section.

(ii) *Other debt instruments.* In the case of a debt instrument described in paragraph (b)(2)(i) of this section that is not subject to the rules of section 163(e) or 1272 through 1288, whether units of nonfunctional currency (or an amount determined with reference to nonfunctional currency) received or paid with respect to such debt instrument are treated as interest or principal shall be determined under section 163 or other applicable section of the Code.

(8) *Limitation of exchange gain or loss on payment or disposition of a debt instrument.* When a debt instrument described in paragraph (b)(2)(i) of this section is paid or disposed of, or when the obligation to make payments thereunder is satisfied by another person, or extinguished or assumed by another person, exchange gain or loss is computed with respect to both principal and any accrued interest (including original issue discount), as provided in paragraph (b)(3) through (7) of

this section. However, pursuant to section 988(b)(1) and (2), the sum of any exchange gain or loss with respect to the principal and interest of any such debt instrument shall be realized only to the extent of the total gain or loss realized on the transaction. The gain or loss realized shall be recognized in accordance with the general principles of the Code. See *Examples 3*, *4* and *6* of paragraph (b)(9) of this section.

(9) *Examples.* The preceding provisions are illustrated in the following examples. The examples assume that any transaction involving an individual is a section 988 transaction.

Example 1. (i) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1992, X converts $13,000 to 10,000 British pounds (£) at the spot rate of £1 = $1.30 and loans the £10,000 to Y for 3 years. The terms of the loan provide that Y will make interest payments of £1,000 on December 31 of 1992, 1993, and 1994, and will repay X's £10,000 principal on December 31, 1994. Assume the spot rates for the pertinent dates are as follows:

Date	Spot rate (pounds to dollars)
Jan. 1, 1992	£1 = $1.30
Dec. 31, 1992	£1 = $1.35
Dec. 31, 1993	£1 = $1.40
Dec. 31, 1994	£1 = $1.45

(ii) Under paragraph (b)(2)(ii)(B) of this section, X will translate the £1,000 interest payments at the spot rate on the date received. Accordingly, X will have interest income of $1,350 in 1992, $1,400 in 1993, and $1,450 in 1994. Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of interest income.

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 principal amount determined by translating the £10,000 at the spot rate on the date it is received (£10,000 × $1.45 = $14,500) and subtracting from such amount, the amount determined by translating the £10,000 at the spot rate on the date the loan was made (£10,000 × $1.30 = $13,000). Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan on December 31, 1994.

Example 2. (i) Assume the same facts as in *Example 1* except that X is an accrual method taxpayer and that average rates are as follows:

Accrual period	Average rate (pounds to dollars)
1992	£1 = $1.32
1993	£1 = $1.37
1994	£1 = $1.42

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will accrue the £1,000 interest payments at the average rate for the accrual period. Accordingly, X will have interest income of $1,320 in 1992, $1,370 in 1993, and $1,420 in 1994. Because X is an accrual basis taxpayer, X determines exchange gain or loss for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting the amounts of interest income accrued for such period. Thus, X will realize $90 of exchange gain with respect to interest received under the loan, computed as follows:

Year	Spot value interest received	Accrued interest @ average rate	Exch. gain
1992	$1,350	$1,320	$30
1993	1,400	1,370	30
1994	1,450	1,420	30
Total	.....	.....	$90

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

Example 3. Assume the same facts as in *Example 1* except that X is a calendar year taxpayer on the accrual method of accounting that elects to use a spot rate convention to translate interest income as provided in §1.988–2(b)(2)(iii)(B). Interest income is received by X on the last day of each accrual period. Under paragraph (b)(2)(ii)(C), X will translate the interest income at the spot rate on the last day of each interest accrual period. Accordingly, X will have interest income of $1,350 in 1992, and $1,400 in 1993, $1,450 in 1994. Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income. Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £10,000 loan principal determined in the same manner as in *Example 1.* Accordingly, X will realize an exchange gain of $1,500 on the repayment of the loan principal on December 31, 1994.

Example 4. Assume the same facts as in *Example 1* except that on December 31, 1993, X sells Y's note for 9,821.13 British pounds (£) after the interest payment. Under paragraph

(b)(8) of this section, X will compute exchange gain on the £10,000 principal. The exchange gain is $1,000 [(£10,000 × $1.40) − (£10,000 × $1.30)]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X's total gain is $749.58 [(£9,821.13 × $1.40) − (£10,000 × $1.30)]. Thus, X will realize $749.58 of exchange gain (and will realize no market loss).

Example 5. (i) The facts are the same as in *Example 1* except that Y becomes insolvent and fails to repay the full £10,000 principal when due. Instead, X and Y agree to compromise the debt for a payment of £8,000 on December 31, 1994. Under paragraph (b)(8) of this section, X will compute exchange gain on the £10,000 originally booked. The exchange gain is $1,500 [(£10,000 × $1.45) − (£10,000 × $1.30) = $1,500]. This exchange gain, however, is only realized to the extent of the total gain on the disposition. X realizes an overall loss on the disposition of $1,400 [(£8,000 × $1.45) − (£10,000 × $1.30) = ($1,400)]. Thus, X will realize no exchange gain (and a $1400 market loss).

(ii) If the exchange rate on December 31, 1994, were £1 = $1.25, rather than £1 = $1.45, X would compute exchange loss under paragraph (b)(8) of this section, on the £10,000 originally booked. The exchange loss would be $500 [(£10,000 × $1.25) − (£10,000 × $1.30) = ($500)]. X's total loss on the disposition would be $3,000 [(£8,000 × $1.25)–(£10,000 × $1.30) = ($3,000)]. Thus, X would realize $500 of exchange loss and a $2,500 market loss on the disposition.

Example 6. (i) X is an individual with the dollar as his functional currency. X is on the cash method of accounting. On January 1, 1989, X borrows 10,000 British pounds (£) from Y, an unrelated person. The terms of the loan provide that X will make interest payments of £1,200 on December 31 of 1989 and 1990 and will repay Y's £10,000 principal on December 31, 1990. The spot rates for the pertinent dates are as follows:

Date	Spot rate [1]
Jan. 1, 1989	1 = $1.50
Dec. 31, 1989	1 = 1.60
Dec. 31, 1990	1 = 1.70

[1] Pounds to dollars.

Assume that the basis of the £1,200 paid as interest by X on December 31, 1989, is $2,000, the basis of the £1,200 paid as interest by X on December 31, 1990, is $2,020 and the basis of the £10,000 principal paid by X on December 31, 1990, is $16,000.

(ii) Under paragraph (b)(2)(ii)(B) of this section, X translates the £1,200 interest payments at the spot rate on the day paid. Thus, X paid $1,920 (£1,200 × $1.60) of interest on December 31, 1989, and $2,040 (£1,200 × $1.70) of interest on December 31, 1990. In addition, X will realize exchange gain or loss on the disposition of the £1,200 on December 31, 1989 and 1990, under paragraph (a) of this section. Pursuant to paragraph (a)(2) of this section, X will realize an exchange loss of $80 [(£1,200 × $1.60) − $2,000] on December 31, 1989, and exchange gain of $20 [(£1,200 × $1.70) − $2,020] on December 31, 1990.

(iii) Under paragraph (b)(6) of this section, X will realize exchange loss on December 31, 1990, upon repayment of the £10,000 principal amount determined by translating the £10,000 received at the spot rate on January 1, 1989 (£10,000 × $1.50 = $15,000) and subtracting from such amount, the amount determined by translating the £10,000 paid at the spot rate on December 31, 1990 (£10,000 × $1.70 = $17,000). Thus, under paragraph (b)(6) of this section, X has an exchange loss with respect to the £10,000 principal of $2,000. Further, under paragraph (a)(2) of this section, X will realize an exchange gain upon disposition of the £10,000 on December 31, 1990. Under paragraph (a)(2) of this section, X will subtract his adjusted basis in the £10,000 ($16,000) from the amount realized upon the disposition of the £10,000 (£10,000 × $1.70 = $17,000) resulting in a gain of $1,000. Accordingly, X's combined exchange gain and loss realized on December 31, 1990, with respect to the repayment of the £10,000 is a $1,000 exchange loss.

Example 7. (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. On January 1, 1989, X purchases at original issue for 82.64 Canadian dollars (C$) M corporation's 2 year note maturing on December 31, 1990, at a stated redemption price of C$100. The yield to maturity in Canadian dollars is 10 percent and the accrual period is the one year period beginning January 1 and ending December 31. The note has C$17.36 of original issue discount. Assume that the spot rates are as follows: C$1 = U.S.$.72 on January 1, 1989; C$1 = U.S.$.80 on January 1, 1990; C$1 = U.S.$ .82 on December 31, 1990. Assume further that the average rate for 1989 is C$1 = U.S.$ .76 and for 1990 is C$1 = U.S. $.81.

(ii) Under paragraph (b)(2)(ii)(A) of this section, X will determine its interest income in Canadian dollars. Accordingly, under section 1272, X must take into account original issue discount in the amount of C$8.26 on December 31, 1989, and C$9.10 on December 31, 1990. Pursuant to paragraph (b)(2)(ii)(C) of this section, X will translate these amounts into U.S. dollars at the average exchange rate for the relevant accrual period. Thus, the amount of interest income taken into account in 1989 is U.S.$6.28 (C$8.26 × U.S.$.76) and in 1990 is U.S.$7.37 (C$9.10 × U.S.$.81). Pursuant to paragraph (b)(3)(ii) of this section, X will realize exchange gain or loss with respect to the accrued interest determined for each accrual period by translating the Canadian dollars received with respect to such accrual period into U.S. dollars at the

spot rate on the date the interest is received and subtracting from that amount the amount accrued in U.S. dollars. Thus, the amount of exchange gain realized on December 31, 1990, is U.S.$.58 (U.S.$.49 from 1989 + U.S.$.09 from 1990). Pursuant to paragraph (b)(5) of this section, X shall realize exchange gain or loss with respect to the principal (C$82.64) on December 31, 1990, computed by translating the C$82.64 at the spot rate on December 31, 1990 (U.S.$67.76) and subtracting the C$82.64 translated at the spot rate on January 1, 1989 (U.S.$59.50) for an exchange gain of U.S.$8.26. Thus, X's combined exchange gain is U.S.$8.84 (U.S.$.49 + U.S.$.09 + U.S.$8.26).

(iii) Assume instead that on January 1, 1990, X sells the note for C$86.95, which it immediately converts to U.S. dollars. X's exchange gain is computed under paragraph (b)(8) of this section with reference to the nonfunctional currency denominated principal amount (C$82.64) and the nonfunctional currency denominated accrued original issue discount (C$8.26). X will compute an exchange gain of U.S.$6.61 with respect to the issue price [(C$82.64 × U.S.$.80) − (C$82.64 × U.S.$.72)] and an exchange gain of U.S.$.33 with respect to the accrued original issue discount [(C$8.26 × U.S.$.80) − (C$8.26 × U.S.$.76)]. Accordingly, prior to the application of paragraph (b)(8) of this section, X's total exchange gain is U.S.$6.94 (U.S.$6.61 + U.S.$.33), and X's market loss is U.S.$3.16 [(C$90.90 − C$86.95) × U.S.$.80]. Pursuant to paragraph (b)(8) of this section, however, X's market loss on the note of U.S.$3.16 is netted against X's exchange gain of U.S.$6.94, resulting in a realized exchange gain of U.S.$3.78 and no market loss.

Example 8. (i) The facts are the same as in *Example 7* (i) except that on January 1, 1990, X contributes the M corporation note to Y, a wholly-owned U.S. subsidiary of X with the dollar as its functional currency, and Y collects C$100 from M corporation at maturity on December 31, 1990, when the spot rate is C$1 = U.S.$.82. The transfer of the note from X to Y qualifies for nonrecognition of gain under section 351(a). On December 31, 1990, Y includes C$9.10 of accrued interest in income which translated at the average exchange rate of C$1 = U.S.$.81 for the year results in U.S.$7.37 of interest income.

(ii) Y's exchange gain is computed under paragraph (b)(3) of this section with respect to accrued interest income and paragraph (b)(5) of this section with respect to the nonfunctional currency principal amount. Under paragraph (b)(3) of this section, Y will realize exchange gain or loss for each accrual period computed by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the day received and subtracting the amounts of interest income accrued for such period. Thus, Y will realize $.49 of exchange gain with respect to original issue discount accrued in 1989 [(C$8.26 × U.S.$.82) − (C$8.26 × U.S.$.76) = U.S. $.49] and $.09 of exchange gain with respect to original issue discount accrued in 1990 [(C$9.10 × U.S.$.82) − (C$9.10 × U.S.$.81) = $.09].

(iii) Pursuant to paragraph (b)(5) of this section, the nonfunctional currency principal amount of the M bond in the hands of Y is C$82.64, the amount carried over from X, the transferor. Y's exchange gain with respect to the nonfunctional currency principal amount is $8.26 [(C$82.64 × U.S.$.82) − (C$82.64 × U.S.$.72) = U.S. $8.26]. Accordingly, Y's combined exchange gain is U.S. $8.84 ($.49 + $.09 + $8.26). Because the amount realized in Canadian dollars equals the adjusted issue price (C$100) on retirement of the M note, there is no market loss, and the netting rule of paragraph (b)(8) of this section does not limit realization of the exchange gain.

Example 9. (i) X is a calendar year corporation on the accrual method of accounting and with the dollar as its functional currency. X elects to use the spot rate convention to translate interest income as provided in paragraph (b)(2)(iii)(B) of this section. On January 31, 1992, X loans £1000 to Y, an unrelated person. Under the terms of the loan, Y will pay X interest of £50 on July 31, 1992, and January 31, 1993, and will repay the £1000 principal on January 31, 1993. Assume the following spot exchange rates:

Date	Spot rate [1]
Jan. 31, 1992	£1 = $1.50
July 31, 1992	£1 = 1.55
Dec. 31, 1992	£1 = 1.60
Jan. 31, 1993	£1 = 1.61

[1] Pounds to dollars.

(ii) Under paragraph (b)(2)(ii)(C) of this section, X will translate the interest income at the spot rate on the last day of each interest accrual period (and in the case of a partial accrual period, at the spot rate on the last day of the taxable year). Accordingly, X will have interest income of $77.50 (£50 × $1.55) on July 31, 1992. Assuming under X's method of accounting that interest is accrued daily, X will accrue $66.50 (153 / 184 × £50) × $1.60) of interest income on December 31, 1992. On January 31, 1993, X will have interest income of $13.60 ((31/184 × £50) × $1.61). Because the rate at which the interest income is translated is the same as the rate on the day of receipt, X will not realize any exchange gain or loss with respect to the interest income received on July 31, 1992. However, X will realize exchange gain on the £41.50 (153/184 × £50) of accrued interest income of $.41 [(£41.50 × $1.61) − (£41.50 × $1.60) = $.41].

(iii) Under paragraph (b)(5) of this section, X will realize exchange gain upon repayment of the £100 principal amount determined by translating the £100 at the spot rate on the date it is received (£100 × $1.61 = $161.00) and

subtracting from such amount, the amount determined by translating the £100 at the spot rate on the date the loan was made (£100 × $1.50 = $150.00). Accordingly, X will realize an exchange gain of $11 on the repayment of the loan on January 31, 1993.

Example 10. (i) X, a cash basis taxpayer with the dollar as its functional currency, has the calendar year as its taxable year. On January 1, 1992, X purchases at original issue for 65.88 British pounds (£) M corporation's 5-year bond maturing on December 31, 1996, having a stated redemption price at maturity of £100. The bond provides for annual payments of interest in pounds of 1 pound per year on December 31 of each year. The bond has 34.12 British pounds of original issue discount. The yield to maturity is 10 percent in British pounds and the accrual period is the one year period beginning January 1 and ending December 31 of each calendar year. The amount of original issue discount is determined in pounds for each accrual period by multiplying the adjusted issue price expressed in pounds by the yield and subtracting from such amount the periodic interest payments expressed in pounds for such period. The periodic interest payments are translated at the spot rate on the payment date (December 31 of each year). The original issue discount is translated at the average rate for the accrual period (January 1 through December 31). The following chart describes the determination of interest income with respect to the facts presented and provides other pertinent information.

TABLE 1

Year (Dec. 31)	Periodic interest payments in pounds for the accrual period	Original issue discount in pounds for the accrual period	Issue price or adjusted issue price in pounds	Assumed spot rate on Dec. 31 (pounds to dollars)	Assumed average rate for accrual period (pounds to dollars)	Periodic interest payments in pounds multiplied by spot rate on the date of payment (column 2 times column 5)	Original issue discount in pounds multiplied by the average rate for the accrual period (column 3 times column 6)	Total interest income in dollars (column 7 plus column 8)	Adjusted issue price in dollars
1	2	3	4	5	6	7	8	9	10
Issue Date:			65.88	1 = $1.20	.....	.....	.....	.....	$79.06
1992	1	5.59	71.47	1 = 1.30	1 = $1.25	$1.30	$6.99	$8.29	86.05
1993	1	6.15	77.62	1 = 1.40	1 = 1.35	1.40	8.30	9.70	94.35
1994	1	6.76	84.38	1 = 1.50	1 = 1.45	1.50	9.80	11.30	104.15
1995	1	7.44	91.82	1 = 1.60	1 = 1.55	1.60	11.53	13.13	115.68
1996	1	8.18	100.00	1 = 1.70	1 = 1.65	1.70	13.50	15.20	129.18

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1996 totaling $7.88 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the average rate for the period. The following chart illustrates this computation:

TABLE 2

Year	OID accrued in pounds for each accrual period	Assumed spot rate on date payment received (pounds to dollars)	Interest received times spot rate on the date received (col. 2 times col. 3)	Assumed average rate for accrual period (pounds to dollars)	IOD in pounds times the average rate for the accrual period (col. 2 times col. 5)	Exchange gain or loss (col. 4 less col. 6)
1	2	3	4	5	6	7
1992	5.59	1 = $1.70	$9.50	1 = $1.25	$6.99	$2.51
1993	6.15	1 = 1.70	10.46	1 = 1.35	8.30	2.16
1994	6.76	1 = 1.70	11.49	1 = 1.45	9.80	1.69
1995	7.44	1 = 1.70	12.65	1 = 1.55	11.53	1.12
1996	8.18	1 = 1.70	13.90	1 = 1.65	13.50	.40
Total	.....	.....	.....	.....	.....	$7.88

(iii) X will also realize exchange gain with respect to the principal of the loan (*i.e.*, the issue price of 65.88 British pounds) on December 31, 1996 computed by translating the units of nonfunctional currency principal received at the spot rate on the date principal is received (65.88 British pounds × $1.70 = $112.00) and subtracting from such amount, the units of nonfunctional currency principal received translated at the spot rate on the date the instrument was acquired (65.88 British pounds × $1.20 = $79.06). Accordingly, X's exchange gain on the principal is $32.94 and X's total exchange gain with respect to the accrued interest and principal is $40.82. It should be noted that, under this fact pattern, the total exchange gain may be determined in an alternative fashion. Exchange gain may be computed by subtracting the adjusted issue price in dollars at maturity ($129.18—see column 10 of Table 1) from the amount computed by multiplying the stated redemption price at maturity in pounds times the spot rate on the maturity date (£100 × $1.70 = $170), which equals $40.82.

Example 11. (i) The facts are the same as in *Example 10* except that X makes an election under paragraph (b)(2)(iii) of this section to translate accrued interest on the last day of the accrual period. Accordingly, columns 8, 9 and 10 in Table 1 would change as follows:

Year (Dec. 31)	Original issue discount in pounds multiplied by the spot rate on last day of accrual period (Dec. 31)	Total interest income in dollars (column 7 plus column 8)	Adjusted issue price in dollars
1	8	9	10
			$79.06
1992	$7.27	$8.57	87.63
1993	8.61	10.01	97.64
1994	10.14	11.64	109.28
1995	11.90	13.50	122.78
1996	13.91	15.61	138.39

(ii) Because X is a cash basis taxpayer, X does not realize exchange gain or loss on the receipt of the £1 periodic interest payments. However, X will realize exchange gain on December 31, 1993 totaling $6.18 with respect to the original issue discount. Exchange gain is determined for each interest accrual period by translating the units of nonfunctional currency interest income received with respect to such accrual period at the spot rate on the date received and subtracting from such amount, the amount computed by translating the units of nonfunctional currency interest income accrued for such period at the spot rate on the last day of the accrual period. Accordingly, columns 5, 6 and 7 of Table 2 would change as follows:

Year	Spot rate on last day of accrual period	OID in pounds times the spot rate on the last day of the accrual period (col 2 times col. 3)	Exchange gain or loss (col. 4 less col. 6)
1	5	6	7
1992	$1.30	$7.27	$2.23
1993	1.40	8.61	1.85
1994	1.50	10.14	1.35
1995	1.60	11.90	0.75
1996	1.70	13.90	0.00
			6.18

(iii) X will realize exchange gain with respect to the principal amount of the loan as provided in the preceding example.

Example 12. (i) C is a corporation that is a calendar year accrual method taxpayer with the dollar as its functional currency. On January 1, 1989, C lends 100 British pounds (£) in exchange for a note under the terms of which C will receive two equal payments of £57.62 on December 31, 1989, and December 31, 1990. Each payment of £57.62 represents the annual payment necessary to amortize the £100 principal amount at a rate of 10% compounded annually over a two year period. The following tables reflect the amounts of principal and interest that compose each payment and assumptions as to the relevant exchange rates:

Date	Principal	Interest
Dec. 31, 1989	£47.62	£10.00
Dec. 12, 1990	£52.38	£5.24

Date	Spot rate £1=	Average rate for year ending
Jan. 1, 1989	$1.30	
Dec. 31, 1989	1.40	1.35
Dec. 31, 1990	1.50	1.45

(ii) Because each interest payment is equal to the product of the outstanding principal balance of the obligation and a single fixed rate of interest, each stated interest payment constitutes periodic interest under the principles of section 1273. Accordingly, there is no original issue discount.

(iii) Because C is an accrual basis taxpayer, C will translate the interest income at the average rate for the annual accrual period pursuant to paragraph (b)(2)(ii)(C) of this section. Thus, C's interest income is $13.50 (£10.00 × $1.35) in 1989, and $7.60 (£5.24 × $1.45) in 1990. C will realize exchange gain or loss upon receipt of accrued interest computed in accordance with paragraph (b)(3) of this section. Thus, C will realize exchange gain in the amount of $.50 [(£10.00 × $1.40) − $13.50] in 1989, and $.26 [(£5.24 × $1.50) − $7.60] in 1990.

(iv) In addition, C will realize exchange gain or loss upon the receipt of principal each year computed under paragraph (b)(5) of this section. Thus, C will realize exchange gain in the amount of $4.76 [(£47.62 × $1.40) − (£47.62 × $1.30)] in 1989, and $10.48 [(£52.38 × $1.50) − (£52.38 × $1.30)] in 1990.

(10) *Treatment of bond premium*—(i) *In general.* Amortizable bond premium on a bond described in paragraph (b)(2)(i) of this section shall be computed in the units of nonfunctional currency in which the bond is denominated (or in which the payments are determined). Amortizable bond premium properly taken into account under section 171 or §1.61–12 (or the successor provision thereof) shall reduce interest income or expense in units of nonfunctional currency. Exchange gain or loss is realized with respect to bond premium described in the preceding sentence by treating the portion of premium amortized with respect to any period as a return of principal. With respect to a holder that does not elect to amortize bond premium under section 171, the amount of bond premium will constitute a market loss when the bond matures. See paragraph (b)(8) of this section. The principles set forth in this paragraph (b)(10) shall apply to determine the treatment of acquisition premium described in section 1272(a)(7).

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(10).

Example. (A) X is an individual on the cash method of accounting with the dollar as his functional currency. On January 1, 1989, X purchases Y corporation's note for 107.99 British pounds (£) from Z, an unrelated party. The note has an issue price of £100, a stated redemption price at maturity of £100, pays interest in pounds at the rate of 10% compounded annually, and matures on December 31, 1993. X elects to amortize the bond premium of £7.99 under the rules of section 171. Pursuant to paragraph (b)(10)(i) of this section, bond premium is determined and amortized in British pounds. Assume the amortization schedule is as follows:

Year ending 12/31	Bond premium amortized	Unamortized premium plus principal	Interest
		£107.99	
1989	£1.36	£106.63	£8.64
1990	£1.47	£105.16	£8.53
1991	£1.59	£103.57	£8.41
1992	£1.71	£101.86	£8.29
1993	£1.85	£100.00	£8.15

(B) The bond premium reduces X's pound interest income under the note. For example, the £10 stated interest payment made in 1989 is reduced by £1.36 of bond premium, and the resulting £8.64 interest income is translated into dollars at the spot rate on December 31, 1989. Exchange gain or loss is realized on the £1.36 bond premium based on the difference between the spot rates on January 1, 1989, the date the premium is paid to acquire the bond, and December 31, 1989, the date the bond premium is returned as part of the stated interest. The £1.36 bond premium reduces the unamortized premium plus principal to £106.63 (£107.99 − £1.36). On December 31, 1993, when the bond matures and the £7.99 of bond premium has been fully amortized, X will realize exchange gain or loss with respect to the remaining purchase price of £100.

(11) *Market discount*—(i) *In general.* Market discount as defined in section 1278(a)(2) shall be determined in units of nonfunctional currency in which the market discount bond is denominated (or in which the payments are determined). Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) shall be translated into functional currency at the spot rate on the date the market discount bond is disposed of. No part of such accrued market discount is treated as exchange gain or loss. Accrued market discount currently includible in income pursuant to section 1278(b) shall be translated into functional currency at the average exchange rate for the accrual period. Exchange gain or loss with respect to accrued market discount currently includible in income under section 1278(b) shall be determined in accordance with paragraph (b)(3) of this section relating to accrued interest income.

(ii) *Example.* The following example illustrates the provisions of this paragraph (b)(11).

Example. (A) X is a calendar year corporation with the U.S. dollar as its functional currency. On January 1, 1990, X purchases a bond of M corporation for 96,530 British pounds (£). The bond, which was issued on January 1, 1989, has an issue price of £100,000, a stated redemption price at maturity of

£100,000, and provides for annual pound payments of interest at 8 percent. The bond matures on December 31, 1991. X purchased the bond at a market discount of 3,470 pounds and did not elect to include the market discount currently in income under section 1278(b). X holds the bond to maturity and on December 31, 1991, receives payment of £100,000 (plus £8,000 interest) when the exchange rate is £1 = $1.50.

(B) Pursuant to paragraph (b)(11) of this section, X computes market discount in units of nonfunctional currency. Thus, the market discount as defined under section 1278(a)(2) is £3,470. Accrued market discount (other than market discount currently included in income pursuant to section 1278(b)) is translated at the spot rate on the date the market discount bond is disposed of. Accordingly, X will translate the accrued market discount of £3,470 at the spot rate on December 31, 1991 (£3,470 × $1.50 = $5,205). No exchange gain or loss is realized with respect to the £3,470 of accrued market discount. See paragraphs (b)(3) and (5) of this section for the realization and recognition of exchange gain or loss with respect to accrued interest and principal.

(12) *Tax exempt bonds.* See §1.988–3(c)(2), which characterizes exchange loss realized with respect to a nonfunctional currency tax exempt bond as a reduction of interest income.

(13) *Nonfunctional currency debt exchanged for stock of obligor*—(i) *In general.* Notwithstanding any other section of the Code other than section 267, 1091 or 1092, exchange gain or loss shall be realized and recognized by the holder and the obligor in accordance with the rules of paragraphs (b)(3) through (7) of this section with respect to the principal and accrued interest of a debt instrument described in paragraph (b)(2)(i) of this section that is acquired by the obligor in exchange for its stock, provided however, that such gain or loss shall be recognized only to the extent of the total gain or loss on the exchange (regardless of whether such gain or loss would otherwise be recognized). This rule shall apply whether the debt instrument is converted into stock according to its terms or exchanged pursuant to a separate agreement between the obligor and the holder. A debt instrument that is acquired by the obligor from a shareholder as a contribution to capital shall be treated for purposes of this section as exchanged for stock, whether or not additional stock is issued.

(ii) *Coordination with section 108.* Section 988 and this section shall apply before section 108. Exchange gain realized by the obligor on an exchange described in paragraph (b)(13)(i) of this section shall not be treated as discharge of indebtedness income, but shall be considered to reduce the amount of the liability for purposes of computing the obligor's income on the exchange under section 108(e)(4), section 108(e)(6) or section 108(e)(10).

(iii) *Effective date.* This paragraph (b)(13) shall be effective for exchanges of debt for stock effected after September 21, 1989.

(iv) *Examples.* The following examples illustrate the operation of this paragraph (b)(13). In each such example, assume that sections 267, 1091 and 1092 do not apply.

Example 1. (i) X is a calendar year U.S. corporation with the U.S. dollar as its functional currency. On January 1, 1990 (the issue date), X acquired a convertible bond maturing on December 31, 1998, issued by Y corporation, a U.K. corporation with the British pound (£) as its functional currency. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. The terms of the bond also provide that at any time prior to December 31, 1998, the holder may surrender all of his interest in the bond in exchange for 20 shares of Y common stock. On January 1, 1994, X surrenders his interest in the bond for 20 shares of Y common stock. Assume the following: (a) The spot rate on January 1, 1990, is £1 = $1.30, (b) The spot rate on January 1, 1994, is £1 = $1.50, and (c) The 20 shares of Y common stock have a market value of £200,000 on January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange gain with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is converted to stock. X will compute exchange gain pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the conversion date (£100.000 × $1.50 = $150,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000 × $1.30 = $130,000). Thus, X will realize and recognize $20,000 of exchange gain. X's basis in the 20 shares of Y common stock is $150,000 ($130,000 substituted basis + $20,000 recognized gain).

Example 2. (i) X, a foreign corporation with the British pound (£) as its functional currency, lends £100 at a market rate of interest to Y, its wholly-owned U.S. subsidiary, on

January 1, 1990, on which date the spot exchange rate is £1 = $1. Y's functional currency is the U.S. dollar. On January 1, 1992, when the spot exchange rate is £1 = $.50, X cancels the debt as a contribution to capital. Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the £100 issue price of the debt instrument on January 1, 1992. Y will compute exchange gain pursuant to paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100 × $1 = $100) and subtracting from such amount the issue price translated at the spot rate on the date of extinguishment (£100 × $.50 = $50). Thus, Y will realize and recognize $50 of exchange gain.

(ii) Under section 108(e)(6), on the acquisition of its indebtedness from X as a contribution to capital Y is treated as having satisfied the debt with an amount of money equal to X's adjusted basis in the debt (£100). For purposes of section 108(e)(6), X's adjusted basis is translated into United States dollars at the spot rate on the date Y acquires the debt (£1 = $.50). Therefore, Y is treated as having satisfied the debt for $50. Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the exchange gain from $100 to $50. Accordingly, Y recognizes $50 of exchange gain and no discharge of indebtedness income on the extinguishment of its debt to X.

(iii) If X were a United States taxpayer with a dollar functional currency and a $100 basis in Y's obligation. X would realize and recognize an exchange loss of $50 under paragraph (b)(5) of this section on the contribution of the debt to Y. The recognized loss would reduce X's adjusted basis in the debt from $100 to $50, so that for purposes of applying section 108(e)(6) Y is treated as having satisfied the debt for $50. Accordingly, under these facts as well Y would recognize $50 of exchange gain and no discharge of indebtedness income.

Example 3. (i) X and Y are unrelated calendar year U.S. corporations with the U.S. dollar as their functional currency. On January 1, 1990 (the issue date), X acquires Y's bond maturing on December 31, 1999. The issue price of the bond is £100,000, the stated redemption price at maturity is £100,000, and the bond provides for annual pound interest payments at the rate of 10%. On January 1, 1994, X and Y agree that Y will redeem its bond from X in exchange for 20 shares of Y common stock. Assume the following:

(a) The spot rate on January 1, 1990, is £1 = $1.00,

(b) The spot rate on January 1, 1994, is £1 = $.50,

(c) Interest rates on equivalent bonds have increased so that as of January 1, 1994, the value of Y's bond has declined to £90,000, and

(d) The 20 shares of Y common stock have a market value of £90,000 as of January 1, 1994.

(ii) Pursuant to paragraph (b)(13) of this section, X will realize and recognize exchange loss with respect to the issue price (£100,000) of the bond on January 1, 1994, when the bond is exchanged for stock. X will compute exchange loss pursuant to paragraph (b)(5) of this section by translating the issue price at the spot rate on the exchange date (£100,000 × $.50 = $50,000) and subtracting from such amount the issue price translated at the spot rate on the date X acquired the bond (£100,000 × $1.00 = $100,000). Thus, X will compute $50,000 of exchange loss, all of which will be realized and recognized because it does not exceed the total $55,000 realized loss on the exchange ($45,000 worth of stock received less $100,000 basis in the exchanged bond).

(iii) Pursuant to paragraph (b)(13) of this section, Y will realize and recognize exchange gain with respect to the issue price, computed under paragraph (b)(6) of this section by translating the issue price at the spot rate on the date Y became the obligor (£100,000 × $1.00 = $100,000) and subtracting from such amount the issue price translated at the spot rate on the exchange date (£100,000 × $.50 = $50,000). Thus, Y will realize and recognize $50,000 of exchange gain. Under section 108(e)(10), on the transfer of stock to X in satisfaction of its indebtedness Y is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock (£90,000 × $.50 = $45,000). Pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $50,000. Accordingly, Y recognizes an additional $5,000 of discharge of indebtedness income on the exchange.

Example 4. (i) The facts are the same as in *Example 3* except that interest rates on equivalent bonds have declined, rather than increased, so that the value of Y's bond on January 1, 1994, has risen to £112,500; and X and Y agree that Y will redeem its bond from X on that date in exchange for 25 shares of Y common stock worth £112,500. Pursuant to paragraphs (b)(13) and (b)(5) of this section, X will compute $50,000 of exchange loss on the exchange with respect to the £100,000 issue price of the bond. See Example 3. However, because X's total loss on the exchange is only $43,750 ($56,250 worth of stock received less $100,000 basis in the exchanged bond), under the netting rule of paragraph (b)(13) of this section the realized exchange loss is limited to $43,750.

(ii) Pursuant to paragraphs (b)(13) and (b)(6) of this section, Y will compute $50,000 of exchange gain with respect to the issue price. See *Example 3.* Under section 108(e)(10), Y is treated as having satisfied the $100,000

indebtedness with an amount of money equal to the fair market value of the stock (£112,500 × $.50 = $56,250), resulting in a total gain on the exchange of $43,750. Accordingly, under paragraph (b)(13) of this section Y's realized (and recognized) exchange gain on the exchange is limited to $43,750. Also pursuant to paragraph (b)(13) of this section, for purposes of section 108 the amount of the indebtedness is considered to be reduced by the recognized exchange gain from $100,000 to $56,250. Accordingly, Y recognizes no discharge of indebtedness income on the exchange.

(14) [Reserved]

(15) *Debt instruments and deposits denominated in hyperinflationary currencies*—(i) *In general.* If a taxpayer issues, acquires, or otherwise enters into or holds a hyperinflationary debt instrument (as defined in paragraph (b)(15)(vi)(A) of this section) or a hyperinflationary deposit (as defined in paragraph (b)(15)(vi)(B) of this section) on which interest is paid or accrued that is denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, then the taxpayer shall realize exchange gain or loss with respect to such instrument or deposit for its taxable year determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the instrument was entered into (or an amount deposited); and

(B) The earlier of the last day of the taxable year, or the date the instrument (or deposit) is disposed of or otherwise terminated.

(ii) *Only exchange gain or loss is realized.* No gain or loss is realized under paragraph (b)(15)(i) by reason of factors other than movement in exchange rates, such as the creditworthiness of the debtor.

(iii) *Special rule for synthetic, non-hyperinflationary currency debt instruments*—(A) *General rule.* Paragraph (b)(15)(i) does not apply to a debt instrument that has interest and principal payments that are to be made by reference to a currency or item that does not reflect hyperinflationary conditions in a country (within the meaning of § 1.988–1(f)).

(B) *Example.* Paragraph (b)(15)(iii)(A) is illustrated by the following example:

Example. When the Turkish lira (TL) is a hyperinflationary currency, A, a U.S. corporation with the U.S. dollar as its functional currency, makes a 5 year, 100,000 TL-denominated loan to B, an unrelated corporation, at a 10% interest rate when 1,000 TL equals $1. Under the terms of the debt instrument, B must pay interest annually to A in amount of Turkish lira that is equal to $100. Also under the terms of the debt instrument, B must pay A upon maturity of the debt instrument an amount of Turkish lira that is equal to $1,000. Although the principal and interest are payable in a hyperinflationary currency, the debt instrument is a synthetic dollar debt instrument and is not subject to paragraph (b)(15)(i) of this section.

(iv) *Source and character of gain or loss*—(A) *General rule for hyperinflationary conditions.* The rules of this paragraph (b)(15)(iv)(A) shall apply to any taxpayer that is either an issuer of (or obligor under) a hyperinflationary debt instrument or deposit and has currency gain on such debt instrument or deposit, or a holder of a hyperinflationary debt instrument or deposit and has currency loss on such debt instrument or deposit. For purposes of subtitle A of the Internal Revenue Code, any exchange gain or loss realized under paragraph (b)(15)(i) of this section is directly allocable to the interest expense or interest income, respectively, from the debt instrument or deposit (computed under this paragraph (b)), and therefore reduces or increases the amount of interest income or interest expense paid or accrued during that year with respect to that instrument or deposit. With respect to a debt instrument or deposit during a taxable year, to the extent exchange gain realized under paragraph (b)(15)(i) of this section exceeds interest expense of an issuer, or exchange loss realized under paragraph (b)(15)(i) of this section exceeds interest income of a holder or depositor, the character and source of such excess amount shall be determined under §§ 1.988–3 and 1.988–4.

(B) *Special rule for subsiding hyperinflationary conditions.* If the taxpayer is an issuer of (or obligor under) a hyperinflationary debt instrument or deposit and has currency loss, or if the taxpayer is a holder of a hyperinflationary debt instrument or deposit and has currency gain, then for

purposes of subtitle A of the Internal Revenue Code, the character and source of the currency gain or loss is determined under §§1.988–3 and 1.988–4. Thus, if an issuer has both interest expense and currency loss, the currency loss is sourced and characterized under section 988, and does not affect the determination of interest expense.

(v) *Adjustment to principal or basis.* Any exchange gain or loss realized under paragraph (b)(15)(i) of this section is an adjustment to the functional currency principal amount of the issuer, functional currency basis of the holder, or the functional currency amount of the deposit. This adjusted amount or basis is used in making subsequent computations of exchange gain or loss, computing the basis of assets for purposes of allocating interest under §§1.861–9T through 1.861–12T and 1.882–5, or making other determinations that may be relevant for computing taxable income or loss.

(vi) *Definitions*—(A) *Hyperinflationary debt instrument.* A hyperinflationary debt instrument is a debt instrument that provides for—

(*1*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the debt instrument; or

(*2*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) during the taxable year, and the terms of the instrument provide for the adjustment of principal or interest payments in a manner that reflects hyperinflation. For example, a debt instrument providing for a variable interest rate based on local conditions and generally responding to changes in the local consumer price index will reflect hyperinflation.

(B) *Hyperinflationary deposit.* A hyperinflationary deposit is a demand or time deposit or similar instrument issued by a bank or other financial institution that provides for—

(*1*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the deposit; or

(*2*) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) during the taxable year, and the terms of the deposit provide for the adjustment of the deposit amount or interest payments in a manner that reflects hyperinflation.

(vii) *Interaction with other provisions*—(A) *Interest allocation rules.* In determining the amount of interest expense, this paragraph (b)(15) applies before §§1.861–9T through 1.861–12T, and 1.882–5.

(B) *DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, paragraph (b)(15)(i) of this section does not apply.

(C) *Interaction with section 988(a)(3)(C).* Section 988(a)(3)(C) does not apply to a debt instrument subject to the rules of paragraph (b)(15)(i) of this section.

(D) *Hedging rules.* To the extent §1.446–4 or 1.988–5 apply, the rules of paragraph (b)(15)(i) of this section will not apply. This paragraph (b)(15)(vii)(D) does not apply if the application of §1.988–5 results in hyperinflationary debt instrument or deposit described in paragraph (b)(15)(vi)(A) or (B) of this section.

(viii) *Effective date.* This paragraph (b)(15) applies to transactions entered into after February 14, 2000.

(16) [Reserved]. For further guidance, see §1.988–2T(b)(16).

(17) *Coordination with installment method under section 453.* [Reserved]

(18) *Interaction of section 988 and §1.1275–2(g)*—(i) *In general.* If a principal purpose of structuring a debt instrument subject to section 988 and any related hedges is to achieve a result that is unreasonable in light of the purposes of section 163(e), section 988, sections 1271 through 1275, or any related section of the Internal Revenue Code, the Commissioner can apply or depart from the regulations under the applicable sections as necessary or appropriate to achieve a reasonable result. For example, if this paragraph (b)(18) applies to a multicurrency debt instrument and a hedge or hedges, the Commissioner can

wholly or partially integrate transactions or treat portions of the debt instrument as separate instruments where appropriate. See also §1.1275–2(g).

(ii) *Unreasonable result.* Whether a result is unreasonable is determined based on all the facts and circumstances. In making this determination, a significant fact is whether the treatment of the debt instrument is expected to have a substantial effect on the issuer's or a holder's U.S. tax liability. Another significant fact is whether the result is obtainable without the application of §1.988–6 and any related provisions (*e.g.*, if the debt instrument and the contingency were entered into separately). A result will not be considered unreasonable, however, in the absence of an expected substantial effect on the present value of a taxpayer's tax liability.

(iii) *Effective date.* This paragraph (b)(18) shall apply to debt instruments issued on or after October 29, 2004.

(c) *Item of expense or gross income or receipts which is to be paid or received after the date accrued*—(1) *In general.* Except as provided in §1.988–5, exchange gain or loss with respect to an item described in §1.988–1(a)(1)(ii) and (2)(ii) (other than accrued interest income or expense subject to paragraph (b) of this section) shall be realized on the date payment is made or received. Except as provided in the succeeding sentence, such exchange gain or loss shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. If the taxpayer's right to receive income, or obligation to pay an expense, is transferred or modified in a transaction in which gain or loss would otherwise be recognized, exchange gain or loss shall be realized and recognized only to the extent of the total gain or loss on the transaction.

(2) *Determination of exchange gain or loss with respect to an item of gross income or receipts.* Exchange gain or loss realized on an item of gross income or receipts described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency received by the spot rate on the payment date, and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency received by the spot rate on the booking date. The term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is received or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of gross income or receipts is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date.

(3) *Determination of exchange gain or loss with respect to an item of expense.* Exchange gain or loss realized on an item of expense described in paragraph (c)(1) of this section shall be determined by multiplying the units of nonfunctional currency paid by the spot rate on the booking date and subtracting from such amount the amount determined by multiplying the units of nonfunctional currency paid by the spot rate on the payment date. The term ''spot rate on the booking date'' means the spot rate determined under §1.988–1(d) on the date the item of expense is accrued or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the booking date. The term ''spot rate on the payment date'' means the spot rate determined under §1.988–1(d) on the date payment is made or otherwise taken into account. Pursuant to §1.988–1(d)(3), a taxpayer may use a spot rate convention for purposes of determining the spot rate on the date.

(4) *Examples.* The following examples illustrate the application of paragraph (c) of this section.

Example 1. X is a calendar year corporation with the dollar as its functional currency. X is on the accrual method of accounting. On January 15, 1989, X sells inventory for 10,000 Canadian dollars (C$). The spot rate on January 15, 1989, is C$1 = U.S. $.55. On February 23, 1989, when X receives payment of the C$10,000, the spot rate is C$1 = U.S. $.50. On February 23, 1989, X will realize exchange loss. X's loss is computed by multiplying the

C$10,000 by the spot rate on the date the C$10,000 are received (C$10,000 × .50 = U.S. $5,000) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate on the booking date (C$10,000 × .55 = U.S. $5,500). Thus, X's exchange loss on the transaction is U.S. $500 (U.S. $5,000 − U.S. $5,500).

Example 2. The facts are the same as in *Example 1* except that X uses a spot rate convention to determine the spot rate as provided in §1.988–1(d)(3). Pursuant to X's spot rate convention, the spot rate at which a payable or receivable is booked is determined monthly for each nonfunctional currency payable or receivable by adding the spot rate at the beginning of the month and the spot rate at the end of the month and dividing by two. All payables and receivables in a nonfunctional currency booked during the month are translated into functional currency at the rate described in the preceding sentence. Further, the translation of nonfunctional currency paid with respect to a payable, and nonfunctional currency received with respect to a receivable, is also performed pursuant to the spot rate convention. Assume the spot rate determined under the spot rate convention for the month of January is C$1 = U.S. $.54 and for the month of February is C$1 = U.S. $.51. On the last date in February, X will realize exchange loss. X's loss is computed by multiplying the C$10,000 by the spot rate convention for the month of February (C$10,000 × U.S. $.51 = U.S. $5,100) and subtracting from such amount, the amount computed by multiplying the C$10,000 by the spot rate convention for the month of January (C$10,000 × U.S. $.54 = $5,400). Thus, X's exchange loss on the transaction is U.S. $300 (U.S. $5,100–U.S. $5,400). X's basis in the C$10,000 is U.S. $5,400.

Example 3. The facts are the same as in *Example 2* except that X has a standing order with X's bank for the bank to convert any nonfunctional currency received in satisfaction of a receivable into U.S. dollars on the day received and to deposit those U.S. dollars in X's U.S. dollar bank account. X may use its convention to translate the amount booked into U.S. dollars, but must use the U.S. dollar amounts received from the bank with respect to such receivables to determine X's exchange gain or loss. Thus, if X receives payment of the C$10,000 on February 23, 1989, when the spot rate is C$1 = U.S.$ .50, X determines exchange gain or loss by subtracting the amount booked under X's convention (U.S.$5,400) from the amount of U.S. dollars received from the bank under the standing conversion order (assume $5,000). X's exchange loss is U.S.$400.

(d) *Exchange gain or loss with respect to forward contracts, futures contracts and option contracts*—(1) *Scope*—(i) *In general.* This paragraph (d) applies to forward contracts, futures contracts and option contracts described in §1.988–1(a)(1)(ii) and (2)(iii). For rules applicable to currency swaps and notional principal contracts described in §1.988–1(a) (1)(ii) and (2)(iii), see paragraph (e) of this section.

(ii) *Treatment of spot contracts.* Solely for purposes of this paragraph (d), a spot contract as defined in §1.988–1(b) to buy or sell nonfunctional currency is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii) unless such spot contract is disposed of (or otherwise terminated) prior to making or taking delivery of the currency. For example, if a taxpayer with the dollar as its functional currency enters into a spot contract to purchase British pounds, and takes delivery of such pounds under the contract, the delivery of the pounds is not a realization event under section 988(c)(5) and paragraph (e)(4)(ii) of this section because the contract is not considered a forward contract or similar transaction described in §1.988–1(a)(2)(iii). However, if the taxpayer sells or otherwise terminates the contract before taking delivery of the pounds, exchange gain or loss shall be realized and recognized in accordance with paragraphs (d)(2) and (3) of this section.

(2) *Realization of exchange gain or loss*—(i) *In general.* Except as provided in §1.988–5, exchange gain or loss on a contract described in §1.988–2(d)(1) shall be realized in accordance with the applicable realization section of the Internal Revenue Code (*e.g.*, sections 1001, 1092, and 1256). See also section 988(c)(5). For purposes of determining the timing of the realization of exchange gain or loss, sections 1092 and 1256 shall take precedence over section 988(c)(5).

(ii) *Realization by offset*—(A) *In general.* Except as provided in paragraphs (d)(2)(ii)(B) and (C) of this section, exchange gain or loss with respect to a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) shall not be realized solely because such transaction is offset by another transaction (or transactions).

(B) *Exception where economic benefit is derived.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is offset by

another transaction or transactions, exchange gain shall be realized to the extent the taxpayer derives, by pledge or otherwise, an economic benefit (*e.g.*, cash, property or the proceeds from a borrowing) from any gain inherent in such offsetting positions. Proper adjustment shall be made in the amount of any gain or loss subsequently realized for gain taken into account by reason of the preceding sentence. This paragraph (d)(2)(ii)(B) shall apply to transactions creating an offset after September 21, 1989.

(C) *Certain contracts traded on an exchange.* If a transaction described in §1.988–1(a)(1)(ii) and (2)(iii) is traded on an exchange and it is the general practice of the exchange to terminate offsetting contracts, entering into an offsetting contract shall be considered a termination of the contract being offset.

(iii) *Clarification of section 988(c)(5).* If the delivery date of a contract subject to section 988(c)(5) and paragraph (d)(4)(ii) of this section is different than the date the contract expires, then for purposes of determining the date exchange gain or loss is realized, the term delivery date shall mean expiration date.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (d)(1) and (2).

Example 1. On August 1, 1989, X, a calendar year corporation with the dollar as its functional currency, enters into a forward contract with Bank A to buy 100 New Zealand dollars for $80 for delivery on January 31, 1990. (The forward purchase contract is not a section 1256 contract.) On November 1, 1989, the market price for the purchase of 100 New Zealand dollars for delivery on January 31, 1990, is $76. On November 1, 1989, X cancels its obligation under the forward purchase contract and pays Bank A $3.95 (the present value of $4 discounted at 12% for the period) in cancellation of such contract. Under section 1001 (a), X realizes an exchange loss of $3.95 on November 1, 1989, because cancellation of the forward purchase contract for cash results in the termination of X's contract.

Example 2. X is a corporation with the dollar as its functional currency. On January 1, 1989, X enters into a currency swap contract with Bank A under which X is obligated to make a series of Japanese yen payments in exchange for a series of dollar payments. On February 21, 1992, X has a gain of $100,000 inherent in such contract as a result of interest rate and exchange rate movements. Also on February 21, 1992, X enters into an offsetting swap with Bank A to lock in such gain. If on February 21, 1992, X pledges the gain inherent in such offsetting positions as collateral for a loan, X's initial swap contract is treated as being terminated on February 21, 1992, under paragraph (d)(2)(ii)(B) of this section. Proper adjustment is made in the amount of any gain or loss subsequently realized for the gain taken into account by reason of paragraph (d)(2)(ii)(B) of this section.

Example 3. X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, X enters into a forward contract to buy 100,000 Swiss francs (Sf) for delivery on March 1, 1990, for $51,220. Assume that the contract is a section 1256 contract under section 1256(g)(2) and that section 1256(e) does not apply. Pursuant to section 1256(a)(1), the forward contract is treated as sold for its fair market value on December 31, 1989. Assume that the fair market value of the contract is $1,000 determined under §1.988–1(g). Thus X will realize an exchange gain of $1,000 on December 31, 1989. Such gain is subject to the character rules of §1.988–3 and the source rules of §1.988–4.

(v) *Extension of the maturity date of certain contracts.* An extension of time for making or taking delivery under a contract described in paragraph (d)(1) of this section (*e.g.*, a historical rate rollover as defined in §1.988–5(b)(2)(iii)(C)) shall be considered a sale or exchange of the contract for its fair market value on the date of the extension and the establishment of a new contract on such date. If, under the terms of the extension, the time value of any gain or loss recognized pursuant to the preceding sentence adjusts the price of the currency to be bought or sold under the new contract, the amount attributable to such time value shall be treated as interest income or expense for all purposes of the Code. However, the preceding sentence shall not apply and the amount attributable to the time value of any gain or loss recognized shall be treated as exchange gain or loss if the period beginning on the first date the contract is rolled over and ending on the date payment is ultimately made or received with respect to such contract does not exceed 183 days.

(3) *Recognition of exchange gain or loss.* Except as provided in §1.988–5 (relating to section 988 hedging transactions),

exchange gain or loss realized with respect to a contract described in paragraph (d)(1) of this section shall be recognized in accordance with the applicable recognition provisions of the Internal Revenue Code. For example, a loss realized with respect to a contract described in paragraph (d)(1) of this section which is part of a straddle shall be recognized in accordance with the provisions of section 1092 to the extent such section is applicable.

(4) *Determination of exchange gain or loss*—(i) *In general.* Exchange gain or loss with respect to a contract described in §1.988–2(d)(1) shall be determined by subtracting the amount paid (or deemed paid), if any, for or with respect to the contract (including any amount paid upon termination of the contract) from the amount received (or deemed received), if any, for or with respect to the contract (including any amount received upon termination of the contract). Any gain or loss determined according to the preceding sentence shall be treated as exchange gain or loss.

(ii) *Special rules where taxpayer makes or takes delivery.* If the taxpayer makes or takes delivery in connection with a contract described in paragraph (d)(1) of this section, any gain or loss shall be realized and recognized in the same manner as if the taxpayer sold the contract (or paid another person to assume the contract) on the date on which he took or made delivery for its fair market value on such date. See paragraph (d)(2)(iii) of this section regarding the definition of the term ''delivery date.'' This paragraph (d)(4)(ii) shall not apply in any case in which the taxpayer makes or takes delivery before June 11, 1987.

(iii) *Examples.* The following examples illustrate the application of paragraph (d)(4) of this section.

Example 1. X is a calendar year corporation with the dollar as its functional currency. On October 1, 1989, when the six month forward rate is $.4907, X enters into a forward contract to buy 100,000 New Zealand dollars (NZD) for delivery on March 1, 1990. On March 1, 1990, when X takes delivery of the 100,000 NZD, the spot rate is 1NZD equals $.48. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery of nonfunctional currency under a forward contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract on March 1, 1990, the transferee would require a payment of $1,070 [($.48 × 100,000NZD) − ($.4907 × 100,000NZD)] to compensate him for the loss in value of the 100,000NZD. Therefore, X realizes an exchange loss of $1,070. X has a basis in the 100,000NZD of $48,000.

Example 2. Assume the same facts as in *Example 1* except that the contract is for Swiss francs and is a section 1256 contract. Assume further that on December 31, 1989, the value to X of the contract as marked to market is $1,000. Pursuant to section 1256(a), X realizes an exchange gain of $1,000. Such gain, however, is characterized as ordinary income under §1.988–3 and will be sourced under §1.988–4.

Example 3. X is a calendar year corporation with the dollar as its functional currency. On May 2, 1989, X enters into an option contract with Bank A to purchase 50,000 Canadian dollars (C$) for U.S. $42,500 (C$1 = U.S. $.85) for delivery on or before September 18, 1989. X pays a $285 premium to Bank A to obtain the option contract. On September 18, 1989, when X exercises the option and takes delivery of the C$50,000, the spot rate is C$1 equals U.S. $.90. Pursuant to section 988(c)(5) and paragraph (d)(4)(ii) of this section, a taxpayer that takes delivery under an option contract that is subject to section 988 is treated as if the taxpayer sold the contract for its fair market value on the date delivery is taken. If X sold the contract for its fair market value on September 18, 1989, X would receive U.S. $2,500 [(C$50,000 × U.S. $.90) − (C$50,000 × U.S. $.85)]. Accordingly, X is deemed to have received U.S. $2,500 on the sale of the contract at its fair market value. X will realize U.S. $2,215 ($2,500 deemed received less $285 paid) of exchange gain with respect to the delivery of Canadian dollars under the option contract. X's basis in the 50,000 Canadian dollars is U.S. $45,000.

(5) *Hyperinflationary contracts*—(i) *In general.* If a taxpayer acquires or otherwise enters into a hyperinflationary contract (as defined in paragraph (d)(5)(ii) of this section) that has payments to be made or received that are denominated in (or determined by reference to) a nonfunctional currency of the taxpayer, then the taxpayer shall realize exchange gain or loss with respect to such contract for its taxable year determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the contract was acquired or entered into; and

(B) The earlier of the last day of the taxable year, or the date the contract is disposed of or otherwise terminated.

(ii) *Definition of hyperinflationary contract.* A hyperinflationary contract is a contract described in paragraph (d)(1) of this section that provides for payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer acquires or otherwise enters into the contract.

(iii) *Interaction with other provisions*—(A) *DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, this paragraph (d)(5) does not apply.

(B) *Hedging rules.* To the extent §1.446–4 or 1.988–5 apply, this paragraph (d)(5) does not apply.

(C) *Adjustment for subsequent transactions.* Proper adjustments must be made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of this paragraph (d)(5).

(iv) *Effective date.* This paragraph (d)(5) is applicable to transactions acquired or otherwise entered into after February 14, 2000.

(e) *Currency swaps and other notional principal contracts*—(1) *In general.* Except as provided in paragraph (e)(2) of this section or in §1.988–5, the timing of income, deduction and loss with respect to a notional principal contract that is a section 988 transaction shall be governed by section 446 and the regulations thereunder. Such income, deduction and loss is characterized as exchange gain or loss (except as provided in another section of the Internal Revenue Code (or regulations thereunder), §1.988–5, or in paragraph (f) of this section).

(2) *Special rules for currency swaps*—(i) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section, the provisions of this paragraph (e)(2) shall apply solely for purposes of determining the realization, recognition and amount of exchange gain or loss with respect to a currency swap contract, and not for purposes of determining the source of such gain or loss, or characterizing such gain or loss as interest. Except as provided in §1.988–3(c), any income or loss realized with respect to a currency swap contract shall be characterized as exchange gain or loss (and not as interest income or expense). Any exchange gain or loss realized in accordance with this paragraph (e)(2) shall be recognized unless otherwise provided in an applicable section of the Code. For purposes of this paragraph (e)(2), a currency swap contract is a contract defined in paragraph (e)(2)(ii) of this section. With respect to a contract which requires the payment of swap principal prior to maturity of such contract, see paragraph (f) of this section. For purposes of this paragraph (e), the rules of paragraph (d)(2)(ii) of this section (regarding realization by offset) apply. See Example 2 of paragraph (d)(2)(iv) of this section.

(ii) *Definition of currency swap contract*—(A) *In general.* A currency swap contract is a contract involving different currencies between two or more parties to—

(*1*) Exchange periodic interim payments, as defined in paragraph (e)(2)(ii)(C) of this section, on or prior to maturity of the contract; and

(*2*) Exchange the swap principal amount upon maturity of the contract.

A currency swap contract may also require an exchange of the swap principal amount upon commencement of the agreement.

(B) *Swap principal amount.* The swap principal amount is an amount of two different currencies which, under the terms of the currency swap contract, is used to determine the periodic interim payments in each currency and which is exchanged upon maturity of the contract. If such amount is not clearly set forth in the contract, the Commissioner may determine the swap principal amount.

(C) *Exchange of periodic interim payments.* An exchange of periodic interim payments is an exchange of one or more payments in one currency specified by the contract for one or more payments in a different currency specified by the contract where the payments in each currency are computed by reference to an interest index applied to the swap principal amount. A currency swap contract must clearly indicate the periodic interim payments, or the interest index used to

compute the periodic interim payments, in each currency.

(iii) *Timing and computation of periodic interim payments*—(A) *In general.* Except as provided in paragraph (e)(2)(iii)(B) of this section and §1.988–5, the timing and computation of the periodic interim payments provided in a currency swap agreement shall be determined by treating—

(*1*) Payments made under the swap as payments made pursuant to a hypothetical borrowing that is denominated in the currency in which payments are required to be made (or are determined with reference to) under the swap, and

(*2*) Payments received under the swap as payments received pursuant to a hypothetical loan that is denominated in the currency in which payments are received (or are determined with reference to) under the swap.

Except as provided in paragraph (e)(2)(v) of this section, the hypothetical issue price of such hypothetical borrowing and loan shall be the swap principal amount. The hypothetical stated redemption price at maturity is the total of all payments (excluding any exchange of the swap principal amount at the inception of the contract) provided under the hypothetical borrowing or loan other than periodic interest payments under the principles of section 1273. For purposes of determining economic accrual under the currency swap, the number of hypothetical interest compounding periods of such hypothetical borrowing and loan shall be determined pursuant to a semiannual compounding convention unless the currency swap contract indicates otherwise. For purposes of determining the timing and amount of the periodic interim payments, the principles regarding the amortization of interest (see generally, sections 1272 through 1275 and 163(e)) shall apply to the hypothetical interest expense and income of such hypothetical borrowing and loan. However, such principles shall not apply to determine the time when principal is deemed to be paid on the hypothetical borrowing and loan. See paragraph (d)(2)(iii) of this section and *Example 2* of paragraph (d)(5) of this section with respect to the time when principal is deemed to be paid. With respect to the translation and computation of exchange gain or loss on any hypothetical interest income or expense, see §1.988–2(b). The amount treated as exchange gain or loss by the taxpayer with respect to the periodic interim payments for the taxable year shall be the amount of hypothetical interest income and exchange gain or loss attributable to such interest income from the hypothetical borrowing and loan for such year less the amount of hypothetical interest expense and exchange gain or loss attributable to the interest expense from such hypothetical borrowing and loan for such year.

(B) *Effect of prepayment for purposes of section 956.* For purposes of section 956, the Commissioner may treat any prepayment of a currency swap as a loan.

(iv) *Timing and determination of exchange gain or loss with respect to the swap principal amount.* Exchange gain or loss with respect to the swap principal amount shall be realized on the day the units of swap principal in each currency are exchanged. (See paragraph (e)(2)(ii)(A)(*2*) of this section which requires that the entire swap principal amount be exchanged upon maturity of the contract.) Such gain or loss shall be determined on the date of the exchange by subtracting the value (on such date) of the units of swap principal paid from the value of the units of swap principal received. This paragraph (e)(2)(iv) does not apply to an equal exchange of the swap principal amount at the commencement of the agreement at a market exchange rate.

(v) *Anti-abuse rules*—(A) *Method of accounting does not clearly reflect income.* If the taxpayer's method of accounting for income, expense, gain or loss attributable to a currency swap does not clearly reflect income, or if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may apply principles analogous to those of section 1274 or such other rules as the Commissioner deems appropriate to clearly reflect income. For

example, in order to clearly reflect income the Commissioner may determine the hypothetical issue price, the hypothetical stated redemption price at maturity, and the amounts required to be taken into account within a taxable year. Further, if the present value of the payments to be made is not equivalent to that of the payments to be received (including the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section) on the day the taxpayer enters into or acquires the contract, the Commissioner may integrate the swap with another transaction (or transactions) in order to clearly reflect income.

(B) *Terms must be clearly stated.* If the currency swap contract does not clearly set forth the swap principal amount in each currency, and the periodic interim payments in each currency (or the interest index used to compute the periodic interim payments in each currency), the Commissioner may defer any income, deduction, gain or loss with respect to such contract until termination of the contract.

(3) *Amortization of swap premium or discount in the case of off-market currency swaps*—(i) *In general.* An ''off-market currency swap'' is a currency swap contract under which the present value of the payments to be made is not equal to that of the payments to be received on the day the taxpayer enters into or acquires the contract (absent the swap premium or discount, as defined in paragraph (e)(3)(ii) of this section). Generally, such present values may not be equal if the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) is not the spot rate, or the interest indices used to compute the periodic interim payments do not reflect current values, on the day the taxpayer enters into or acquires the currency swap.

(ii) *Treatment of taxpayer entering into or acquiring an off-market currency swap.* If a taxpayer that enters into or acquires a currency swap makes a payment (that is, the taxpayer pays a premium, ''swap premium,'' to enter into or acquire the currency swap) or receives a payment (that is, the taxpayer enters into or acquires the currency swap at a discount, ''swap discount'') in order to make the present value of the amounts to be paid equal the amounts to be received, such payment shall be amortized in a manner which places the taxpayer in the same position it would have been in had the taxpayer entered into a currency swap contract under which the present value of the amounts to be paid equal the amounts to be received (absent any swap premium or discount). Thus, swap premium or discount shall be amortized as follows—

(A) The amount of swap premium or discount that is attributable to the difference between the swap exchange rate (as defined in paragraph (e)(3)(iii) of this section) and the spot rate on the date the contract is entered into or acquired shall be taken into account as income or expense on the date the swap principal amounts are taken into account; and

(B) The amount of swap premium or discount attributable to the difference in values of the periodic interim payments shall be amortized in a manner consistent with the principles of economic accrual. *Cf.*, section 171.

Any amount taken into account pursuant to this paragraph (e)(3)(ii) shall be treated as exchange gain or loss.

(iii) *Definition of swap exchange rate.* The swap exchange rate is the single exchange rate set forth in the contract at which the swap principal amounts are determined. If the swap exchange rate is not clearly set forth in the contract, the Commissioner may determine such rate.

(iv) *Coordination with § 1.446–3(g)(4) regarding swaps with significant nonperiodic payments.* The rules of § 1.446–3(g)(4) apply to any currency swap with a significant nonperiodic payment. Section 1.446–3(g)(4) applies before this paragraph (e)(3). Thus, if § 1.446–3(g)(4) applies, currency gain or loss may be realized on the loan. This paragraph (e)(3)(iv) applies to transactions entered into after February 14, 2000.

(4) *Treatment of taxpayer disposing of a currency swap.* Any gain or loss realized on the disposition or the termination of a currency swap is exchange gain or loss.

(5) *Examples.* The following examples illustrate the application of this paragraph (e).

Example 1. (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, C enters into a currency swap with J with the following terms:

(1) the principal amount is $150 and 100 British pounds (£) (the equivalent of $150 on the effective date of the contract assuming a spot rate of £1 = $1.50 on January 1, 1989);

(2) C will make payments equal to 10% of the dollar principal amount on December 31, 1989, and December 31, 1990;

(3) J will make payments equal to 12% of the pound principal amount on December 31, 1989, and December 31, 1990; and

(4) on December 31, 1990, C will pay to J the $150 principal amount and J will pay to C the £100 principal amount.

Assume that the spot rate is £1 = $1.50 on January 1, 1989, £1 = $1.40 on December 31, 1989, and £1 = $1.30 on December 31, 1990. Assume further that the average rate for 1989 is £1 = $1.45 and for 1990 is £1 = $1.35.

(ii) Solely for determining the realization of gain or loss in accordance with paragraph (e)(2) of this section (and not for purposes of determining whether any payments are treated as interest), C will treat the dollar payments made by C as payments made pursuant to a dollar borrowing with an issue price of $150, a stated redemption price at maturity of $150, and yield to maturity of 10%. C will treat the pound payments received as payments received pursuant to a pound loan with an issue price of £100, a stated redemption price at maturity of £100, and a yield of 12% to maturity. Pursuant to §1.988–2(b), C is required to compute hypothetical accrued pound interest income at the average rate for the accrual period and then determine exchange gain or loss on the day payment is received with respect to such accrued amount. Accordingly, C will accrue $17.40 (£12 × $1.45) in 1989 and $16.20 (£12 × $1.35) in 1990. C also will compute hypothetical exchange loss of $.60 on December 31, 1989 [(£12 × $1.40) − (£12 × $1.45)] and hypothetical exchange loss of $.60 on December 31, 1990 [(£12 × $1.30) − (£12 × $1.35)]. All such hypothetical interest income and exchange loss are characterized and sourced as exchange gain and loss. Further, C is treated as having paid $15 ($150 × 10%) of hypothetical interest on December 31, 1989, and again on December 31, 1990. Such hypothetical interest expense is characterized and sourced as exchange loss. Thus, C will have a net exchange gain of $1.80 ($17.40 − $.60 − $15.00) with respect to the periodic interim payments in 1989 and a net exchange gain of $.60 ($16.20 − $.60 − $15.00) with respect to the periodic interim payments in 1990. Finally, C will realize an exchange loss on December 31, 1990, with respect to the exchange of the swap principal amount. This loss is determined by subtracting the value of the units of swap principal paid ($150) from the value of the units of swap principal received (£100 × $1.30 = $130) resulting in a $20 exchange loss.

Example 2. (i) C is an accrual method calendar year corporation with the dollar as its functional currency. On January 1, 1989, when the spot rate is £1 = $1.50, C enters into a currency swap contract with J under which C agrees to make and receive the following payments:

Date	C pays	J pays
December 31, 1989	$15.00	£12.00
December 31, 1990	41.04	12.00
December 31, 1991	0.00	12.00
December 31, 1992	150.00	112.00

(ii) Under paragraph (e)(2)(iii) of this section, C must treat the dollar periodic interim payments under the swap as made pursuant to a hypothetical dollar borrowing. The hypothetical issue price is $150 and the stated redemption price at maturity is $206.04. The amount of hypothetical interest expense must be amortized in accordance with economic accrual. Thus J must include and C must deduct periodic interim payment amounts as follows:

	Amount taken into account	Adjusted issue price
December 31, 1989	$15.00	150.00
December 31, 1990	$15.00	123.96
December 31, 1991	$12.40	136.36
December 31, 1992	$13.64	

(iii) Gain or loss with respect to the periodic interim payments of the currency swap is determined under paragraph (e)(2)(iii)(A) of this section with respect to the dollar cash flow amortized as set forth above and the corresponding pound cash flow as stated in the currency swap contract. Gain or loss with respect to the principal payments (*i.e.*, $150 and £100) exchanged on December 31, 1992, is determined under paragraph (e)(2)(iv) of this section on December 31, 1992, notwithstanding that under the principles regarding amortization of interest $26.04 would have been regarded as a payment of principal on December 31, 1990.

Example 3. (i) X is a corporation on the accrual method of accounting with the dollar as its functional currency and the calendar year as its taxable year. On January 1, 1989, X enters into a three year currency swap contract with Y with the following terms. The swap principal amount is $100 and the Swiss franc (Sf) equivalent of such amount

which equals Sf200 translated at the swap exchange rate of $1 = Sf2. There is no initial exchange of the swap principal amount. The interest rates used to compute the periodic interim payments are 10% compounded annually for U.S. dollar payments and 5% compounded annually for Swiss franc payments. Thus, under the currency swap, X agrees to pay Y $10 (10% × $100) on December 31st of 1989, 1990 and 1991 and to pay Y the swap principal amount of $100 on December 31, 1991. Y agrees to pay X Sf10 (5% × Sf200) on December 31st of 1989, 1990 and 1991 and to pay X the swap principal amount of Sf200 on December 31, 1991. Assume that the average rate for 1989 and the spot rate on December 31, 1989, is $1 = Sf2.5.

(ii) Under paragraph (e)(2)(iii) of this section, on December 31, 1989, X will realize an exchange loss of $6 (the sum of $10 of loss by reason of the $10 periodic interim payment paid to Y and $4.00 of gain, the value of Sf10 on December 31, 1989, from the receipt of Sf10 on such date).

(iii) On January 1, 1990, X transfers its rights and obligations under the swap contract to Z, an unrelated corporation. Z has the dollar as its functional currency, is on the accrual method of accounting, and has the calendar year as its taxable year. On January 1, 1990, the exchange rate is $1 = Sf2.50. The relevant dollar interest rate is 8% compounded annually and the relevant Swiss franc interest rate is 5% compounded annually. Because of the movement in exchange and interest rates, the agreement between X and Z to transfer the currency swap requires X to pay Z $23.56 (the swap discount as determined under paragraph (e)(3) of this section).

(iv) Pursuant to paragraph (e)(4) of this section, X may deduct the loss of $23.56 in 1990. The loss is characterized under § 1.988–3 and sourced under § 1.988–4.

(v) Pursuant to paragraph (e)(3)(ii) of this section, Z is required to amortize the $23.56 received as follows. The amount of the $23.56 payment that is attributable to movements in exchange rates ($20) is taken into account on December 31, 1991, the date the swap principal amounts are exchanged, under paragraph (e)(3)(ii)(A) of this section. This amount is the present value (discounted at 10%, the rate under the currency swap contract used to compute the dollar periodic interim payments) of the financial asset required to compensate Z for the loss in value of the hypothetical Swiss franc loan resulting from movements in exchange rates between January 1, 1989, and January 1, 1990. This amount is determined by assuming that interest rates did not change from the date the swap originally was entered into (January 1, 1989), but that the exchange rate is $1 = Sf2.50. Under this assumption, a taxpayer undertaking the obligation to pay dollars under the currency swap on January 1, 1990, would only agree to pay $8 for Sf10 on December 31, 1990, and $88 for Sf210 on December 31, 1991, because the exchange rates have moved from $1 = Sf2 to $1 = Sf2.50. Thus, Z requires $2 on December 31, 1990, and $22 on December 31, 1991, to compensate for the amount of dollar payments Z is required to make in exchange for the Swiss francs received on December 31, 1990 and 1991. The present value of $2 on December 31, 1990, and $22 on December 31, 1991, discounted at the rate for U.S. dollar payments of 10% is $20 ($1.82 + $18.18). This amount is discounted at the rate for U.S. dollar payments (i.e., at the historic rate) because the amount of the $23.56 payment received by Z that is attributable to movements in interest rates is computed and amortized separately as provided in the following paragraph.

(vi) Pursuant to paragraph (e)(3)(ii)(B) of this section, Z is required to amortize the portion of the $23.56 payment attributable to movements in interest rates under principles of economic accrual over the term of the currency swap agreement. The amount of the $23.56 payment that is attributable to movements in interest rates (assuming that exchange rates have not changed) is the present value ($3.56) of the excess ($2.00 in 1990 and $2.00 in 1991) of the periodic interim payments Z is required to pay under the currency swap agreement ($10 in 1990 and $10 in 1991) over the amount Z would be required to pay if the currency swap agreement reflected current interest rates on the day Z acquired the swap contract ($8 in 1990 and $8 in 1991) discounted at the appropriate dollar interest rate on January 1, 1990. Thus, under principles of economic accrual (e.g., see section 171 of the Code), Z will include in income $1.72 on December 31, 1990, the amount that, when added to the interest ($.28) on the $3.56 computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1989, and January 1, 1990. Z also will include in income $1.85 on December 31, 1991, the amount that, when added to the interest ($.15) on the $1.85 (the remaining balance of the $3.56 payment) computed at the 8% rate on the date Z acquired the currency swap contract, will equal the $2.00 needed to compensate Z for the movement in interest rates between January 1, 1990, and January 1, 1991. This amount is computed assuming exchange rates have not changed because the amount attributable to movements in exchange rates is computed and amortized separately under the preceding paragraph.

(6) *Special effective date for rules regarding currency swaps.* Paragraph (e)(3) of this section regarding amortization of swap premium or discount in the case of off-market currency swaps shall be effective for transactions entered

into after September 21, 1989, unless such swap premium or discount was paid or received pursuant to a binding contract with an unrelated party that was entered into prior to such date. For transactions entered into prior to this date, see Notice 89–21, 1989–8 I.R.B. 23.

(7) *Special rules for currency swap contracts in hyperinflationary currencies*—(i) *In general.* If a taxpayer enters into a hyperinflationary currency swap (as defined in paragraph (e)(7)(iv) of this section), then the taxpayer realizes exchange gain or loss for its taxable year with respect to such instrument determined by reference to the change in exchange rates between—

(A) The later of the first day of the taxable year, or the date the instrument was entered into (by the taxpayer); and

(B) The earlier of the last day of the taxable year, or the date the instrument is disposed of or otherwise terminated.

(ii) *Adjustment to principal or basis.* Proper adjustments are made in the amount of any gain or loss subsequently realized for gain or loss taken into account by reason of this paragraph (e)(7).

(iii) *Interaction with DASTM.* With respect to a qualified business unit that uses the United States dollar approximate separate transactions method of accounting described in §1.985–3, this paragraph (e)(7) does not apply.

(iv) *Definition of hyperinflationary currency swap contract.* A hyperinflationary currency swap contract is a currency swap contract that provides for—

(A) Payments denominated in or determined by reference to a currency that is hyperinflationary (as defined in §1.988–1(f)) at the time the taxpayer enters into or otherwise acquires the currency swap; or

(B) Payments that are adjusted to take into account the fact that the currency is hyperinflationary (as defined in §1.988–1(f)) during the current taxable year. A currency swap contract that provides for periodic payments determined by reference to a variable interest rate based on local conditions and generally responding to changes in the local consumer price index is an example of this latter type of currency swap contract.

(v) *Special effective date for nonfunctional hyperinflationary currency swap contracts.* This paragraph (e)(7) applies to transactions entered into after February 14, 2000.

(f) *Substance over form*—(1) *In general.* If the substance of a transaction described in §1.988–1(a)(1) differs from its form, the timing, source, and character of gains or losses with respect to such transaction may be recharacterized by the Commissioner in accordance with its substance. For example, if a taxpayer enters into a transaction that it designates a ''currency swap contract'' that requires the prepayment of all payments to be made or to be received (but not both), the Commissioner may recharacterize the contract as a loan. In applying the substance over form principle, separate transactions may be integrated where appropriate. See also §1.861–9T(b)(1).

(2) *Example.* The following example illustrates the provisions of this paragraph (f).

Example. (i) On January 1, 1990, X, a U.S. corporation with the dollar as its functional currency, enters into a contract with Y under which X will pay Y $100 and Y will pay X LC100 on January 1, 1990, and X will pay Y LC109.3 and Y will pay X $133 on December 31, 1992. On January 1, 1990, the spot exchange rate is LC1 = $1 and the 3 year forward rate is LC1 = $.8218. X's cash flows are summarized below:

Date	Dollar	LC
1/1/90	(100)	100
12/31/90	0	0
12/31/91	0	0
12/31/92	133	(109.3)

(ii) X and Y designate this contract as a ''currency swap.'' Notwithstanding this designation, for purposes of determining the timing, source, and character with respect to the transaction, the transaction is characterized by the Commissioner in accordance with its substance. Thus, the January 1, 1990, exchange by X of $100 for LC 100 is treated as a spot purchase of LCs by X and the December 31, 1992, exchange by X at 109.3LC for $133 is treated as a forward sale of LCs by X. Under such treatment there would be no tax consequences to X under paragraph (e)(2) of this section in 1990, 1991, and 1992 with respect to this transaction other than the realization of exchange gain or loss on the sale

of the LC109.3 on December 31, 1992. Calculation of such gain or loss would be governed by the rules of paragraph (d) of this section.

(g) *Effective date.* Except as otherwise provided in this section, this section shall be effective for taxable years beginning after December 31, 1986. Thus, except as otherwise provided in this section, any payments made or received with respect to a section 988 transaction in taxable years beginning after December 31, 1986, are subject to this section.

(h) *Timing of income and deductions from notional principal contracts.* Except as otherwise provided (e.g., in §1.988–5 or §1.446–3(g)), income or loss from a notional principal contract described in §1.988–1(a)(2)(iii)(B) (other than a currency swap) is exchange gain or loss. For the rules governing the timing of income and deductions with respect to notional principal contracts, see §1.446–3. See paragraph (e)(2) of this section with respect to currency swaps.

(i) [Reserved]. For further guidance, see §1.988–2T(i).

[T.D. 8400, 57 FR 9183, Mar. 17, 1992, as amended by T.D. 8491, 58 FR 53135, Oct. 14, 1993; T.D. 8860, 65 FR 2028, Jan. 13, 2000; T.D. 9157, 69 FR 52819, Aug. 30, 2004; T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§1.988–2T Recognition and computation of exchange gain or loss (temporary).

(a) through (b)(15) [Reserved]. For further guidance, see §1.988–2(a) through (b)(15).

(16) *Deferral of loss on certain related-party debt instruments*—(i) *Treatment of creditor.* For rules applicable to a corporation included in a controlled group that is a creditor under a debt instrument see §1.267(f)–1(e).

(ii) *Treatment of debtor*—(A) *In general.* Exchange loss realized under §1.988–2(b)(4) or (b)(6) is deferred if—

(*1*) The loss is realized by a debtor with respect to a loan from a person that has a relationship to the debtor described in section 267(b) or section 707(b); and

(*2*) The transaction resulting in the realization of exchange loss has as a principal purpose the avoidance of Federal income tax.

(B) *Recognition of deferred loss.* Any exchange loss that is deferred under paragraph (b)(16)(ii)(A) of this section is deferred until the end of the term of the loan, determined immediately prior to the transaction.

(17) through (h) [Reserved]. For further guidance, see §1.988–2(b)(17) through (h).

(i) *Special rules for section 988 transactions of a section 987 QBU.* For rules regarding section 988 transactions of a section 987 QBU, see §1.987–3T(b)(4) for section 987 QBUs in general and §1.987–1T(b)(6) for dollar QBUs.

(j) *Effective/applicability date.* Paragraph (b)(16) of this section applies to any exchange loss realized on or after December 7, 2016. Paragraph (i) of this section applies to taxable years beginning on or after one year after the first day of the first taxable year following December 7, 2016. Notwithstanding the preceding sentence, if a taxpayer makes an election under §1.987–11(b), then paragraph (i) of this section applies to taxable years to which §§1.987–1 through 1.987–10 apply as a result of such election.

(k) *Expiration date.* The applicability of this section expires on December 6, 2019.

[T.D. 9795, 81 FR 88879, Dec. 8, 2016]

§1.988–3 Character of exchange gain or loss.

(a) *In general.* The character of exchange gain or loss recognized on a section 988 transaction is governed by section 988 and this section. Except as otherwise provided in section 988(c)(1)(E), section 1092, §1.988–5 and this section, exchange gain or loss realized with respect to a section 988 transaction (including a section 1256 contract that is also a section 988 transaction) shall be characterized as ordinary gain or loss. Accordingly, unless a valid election is made under paragraph (b) of this section, any section providing special rules for capital gain or loss treatment, such as sections 1233, 1234, 1234A, 1236 and 1256(f)(3), shall not apply.

(b) *Election to characterize exchange gain or loss on certain identified forward contracts, futures contracts and option contracts as capital gain or loss*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, a taxpayer may elect, subject to the requirements