then any gain or loss on the hedge shall be an adjustment to the amount realized or the adjusted basis of the stock or securities sold or purchased (and shall not be taken into account as exchange gain or loss). The term hedge means a deposit of nonfunctional currency in a hedging account (within the meaning of paragraph (b)(2)(iii)(D) of this section), or a forward or futures contract described in §1.988–1(a)(1)(ii) and (2)(iii), or combination thereof, which reduces the risk of exchange rate fluctuations for any portion of the period beginning on the trade date and ending on the settlement date. The provisions of paragraphs (b)(2)(i)(D) through (G), and (b)(2)(iii)(D) and (E) of this section shall apply. Sections 263(g), 1092, and 1256 do not apply with respect to stock or securities and a hedge which are subject to this paragraph (c).

(d) [Reserved]

(e) *Advance rulings regarding net hedging and anticipatory hedging systems.* In his sole discretion, the Commissioner may issue an advance ruling addressing the income tax consequences of a taxpayer's system of hedging either its net nonfunctional currency exposure or anticipated nonfunctional currency exposure. The ruling may address the character, source, and timing of both the section 988 transaction(s) making up the hedge and the underlying transactions being hedged. The procedures for obtaining a ruling shall be governed by such pertinent revenue procedures and revenue rulings as the Commissioner may provide. The Commissioner will not issue a ruling regarding hedges of a taxpayer's investment in a foreign subsidiary.

(f) [Reserved]

(g) *General effective date.* Except as otherwise provided in this section, the rules of this section shall apply to qualified hedging transactions, hedged executory contracts and transactions described in paragraph (c) of this section entered into on or after September 21, 1989. This section shall apply even if the transaction being hedged (*e.g.*, the debt instrument) was entered into or acquired prior to such date. The effective date regarding advance rulings for net and anticipatory hedging shall be governed by such revenue procedures that the Commissioner may publish.

[T.D. 8400, 57 FR 9199, Mar. 17, 1992, as amended at T.D. 9598, 77 FR 54809, Sept. 6, 2012]

§ 1.988–5T Section 988(d) hedging transactions (temporary).

(a) through (a)(6)(i) [Reserved] For further guidance see §1.988–5(a) through (a)(6)(i).

(ii) *Legging out.* With respect to a qualifying debt instrument and hedge that are properly identified as a qualified hedging transaction, ''legging out'' of integrated treatment under this paragraph (a) means that the taxpayer disposes of or otherwise terminates all or any portion of the qualifying debt instrument or the hedge prior to maturity of the qualified hedging transaction, or the taxpayer changes a material term of the qualifying debt instrument (for example, exercises an option to change the interest rate or index, or the maturity date) or the hedge (for example, changes the interest or exchange rates underlying the hedge, or the expiration date) prior to maturity of the qualified hedging transaction. A taxpayer that disposes of or terminates a qualified hedging transaction (that is, disposes of or terminates both the qualifying debt instrument and the hedge in their entirety on the same day) shall be considered to have disposed of or otherwise terminated the synthetic debt instrument rather than legging out. If a taxpayer legs out of integrated treatment, the following rules shall apply:

(A) The transaction will be treated as a qualified hedging transaction during the time the requirements of this paragraph (a) were satisfied.

(B) If all of the instruments comprising the hedge (each such instrument, a component) are disposed of or otherwise terminated, the qualifying debt instrument shall be treated as sold for its fair market value on the date the hedge is disposed of or otherwise terminated (the leg-out date), and any gain or loss (including gain or loss resulting from factors other than movements in exchange rates) from the identification date to the leg-out date is realized and recognized on the leg-out date. The spot rate on the leg-out date shall be used to determine exchange gain or loss on the debt instrument for the period beginning on the leg-out date and ending on the date such instrument matures or is disposed of or otherwise terminated. Proper adjustment must be made to reflect any gain or loss taken into account. The netting rule of §1.988–2(b)(8) shall apply.

(C) If a hedge has more than one component (and such components have been properly identified as being part of the qualified hedging transaction) and at least one but not all of the components that comprise the hedge has been disposed of or otherwise terminated, or if part of any component of the hedge has been terminated (whether a hedge consists of a single or multiple components), the date such component (or part thereof) is disposed of or terminated shall be considered the leg-out date and the qualifying debt instrument shall be treated as sold for its fair market value in accordance with the rules of paragraph (a)(6)(ii)(B) of this section on such leg-out date. In addition, all of the remaining components (or parts thereof) that have not been disposed of or otherwise terminated shall be treated as sold for their fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. To the extent relevant, the spot rate on the leg-out date shall be used to determine exchange gain or loss on the remaining components (or parts thereof) for the period beginning on the leg-out date and ending on the date such components (or parts thereof) are disposed of or otherwise terminated.

(D) If the qualifying debt instrument is disposed of or otherwise terminated in whole or in part, the date of such disposition or termination shall be considered the leg-out date. Accordingly, the hedge (including all components making up the hedge in their entirety) that is part of the qualified hedging transaction shall be treated as sold for its fair market value on the leg-out date, and any gain or loss from the identification date to the leg-out date is realized and recognized on the leg-out date. To the extent relevant, the spot rate on the leg-out date shall be used to determine exchange gain or loss on the hedge (including all components thereof) for the period beginning on the leg-out date and ending on the date such hedge is disposed of or otherwise terminated.

(E) Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the part of the qualified hedging transaction that has not been terminated (that is, the remaining debt instrument in its entirety even if partially hedged, or the remaining components of the hedge) cannot be part of a qualified hedging transaction for any period subsequent to the leg-out date.

(F) If a taxpayer legs out of a qualified hedging transaction and realizes a gain with respect to the disposed of or terminated debt instrument or hedge, then paragraph (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if during the period beginning 30 days before the leg-out date and ending 30 days after that date the taxpayer enters into another transaction that, taken together with any remaining components of the hedge, hedges at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction or, if appropriate, an equivalent amount under the hedge (or any remaining components thereof) that was part of the qualified hedging transaction. Similarly, in a case in which a hedge has multiple components that are part of a qualified hedging transaction, if the taxpayer legs out of a qualified hedging transaction by terminating one such component or a part of one or more such components and realizes a gain with respect to the terminated component, components, or portions thereof, then paragraphs (a)(6)(ii)(B), (C), and (D) of this section, as appropriate, will not apply if the remaining components of the hedge (including parts thereof) by themselves hedge at least 50 percent of the remaining currency flow with respect to the qualifying debt instrument that was part of the qualified hedging transaction.

(a)(7) through (a)(9)(iv) *Examples 10* [Reserved] For further guidance see §1.988–5(a)(7) through (a)(9)(iv) *Example 10*.

Example 11. (i) K is a U.S. corporation with the U.S. dollar as its functional currency. On January 1, 2013, K borrows 100 British pounds (£) for two years at a 10% rate of interest payable on December 31 of each year with no principal payment due until maturity on December 31, 2014. Assume that the spot rate on January 1, 2013, is £1=$1. On the same date, K enters into two swap contracts with an unrelated counterparty that economically results in the transformation of the fixed rate £100 borrowing to a floating rate dollar borrowing. The terms of the swaps are as follows:

(A) *Swap #1, Currency swap.* On January 1, 2013, K will exchange £100 for $100.

(*1*) On December 31 of both 2013 and 2014, K will exchange $8 for £10;

(*2*) On December 31, 2014, K will exchange $100 for £100.

(B) *Swap #2, Interest rate swap.* On December 31 of both 2013 and 2014, K will pay LIBOR times a notional principal amount of $100 and will receive 8% times the same $100 notional principal amount.

(ii) Assume that K properly identifies the pound borrowing and the swap contracts as a qualified hedging transaction as provided in paragraph (a)(8) of this section and that the other relevant requirements of paragraph (a) of this section are satisfied.

(iii) Assume also that on January 1, 2014, the spot exchange rate is £1:$2; the U.S. dollar LIBOR rate of interest is 9%; and the market value of K's note in pounds has not changed. K terminates swap #2. K will incur a loss of ($.91) (the present value of $1) with respect to the termination of such swap on January 1, 2014. Pursuant to paragraph (a)(6)(ii)(C) of this section, K must treat swap #1 as having been sold for its fair market value on the leg-out date, which is the date swap #2 is terminated. K must realize and recognize gain of $100.92 [the present value of £110 discounted in pounds to equal £100 × $2 ($200) less the present value of $108 ($99.08)]. The loss inherent in the pound borrowing from January 1, 2013 to January 1, 2014 is realized and recognized on January 1, 2014. Such loss is exchange loss in the amount of $100 [the present value of £110 that was to be paid at the end of the year discounted at pound interest rates to equal £100 times the change in exchange rates: (£100 × $1, the spot rate on January 1, 2013) − (£100 × $2, the spot rate on January 1, 2014)]. Except as provided in paragraph (a)(8)(iii) of this section (regarding identification by the Commissioner), the pound borrowing and currency swap cannot be part of a qualified hedging transaction for any period subsequent to the leg-out date.

(iv) Assume the facts are the same as in paragraph (iii) of this section except that on January 1, 2014, the U.S. dollar LIBOR rate of interest is 7% rather than 9%. When K terminates swap #2, K will realize gain of $0.93 (the present value of $1) received with respect to the termination on January 1, 2014. Fifty percent or more of the remaining pound cash flow of the pound borrowing remains hedged after the termination of swap #2. Accordingly, under paragraph (a)(6)(ii)(F) of this section, paragraphs (a)(6)(ii)(B) and (C) of this section do not apply and the gain on swap #1 and the loss on the qualifying debt instrument is not taken into account. Thus, K will include in income $0.93 realized from termination of swap #2.

(a)(10) through (g) [Reserved] For further guidance see §1.988–5(a)(10) through (g).

(h) *Effective/applicability date.* This section applies to leg-outs that occur on or after September 6, 2012.

(i) *Expiration date.* This section expires on September 4, 2015.

[T.D. 9598, 77 FR 54810, Sept. 6, 2012, T.D. 9598, 77 FR 57013, Sept. 17, 2012]

§ 1.988–6 Nonfunctional currency contingent payment debt instruments.

(a) *In general*—(1) *Scope.* This section determines the accrual of interest and the amount, timing, source, and character of any gain or loss on nonfunctional currency contingent payment debt instruments described in this paragraph (a)(1) and to which §1.1275–4(a) would otherwise apply if the debt instrument were denominated in the taxpayer's functional currency. Except as provided by the rules in this section, the rules in §1.1275–4 (relating to contingent payment debt instruments) apply to the following instruments—

(i) A debt instrument described in §1.1275–4(b)(1) for which all payments of principal and interest are denominated in, or determined by reference to, a single nonfunctional currency and which has one or more non-currency related contingencies;

(ii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has no non-currency related contingencies;

(iii) A debt instrument described in §1.1275–4(b)(1) for which payments of principal or interest are denominated in, or determined by reference to, more than one currency and which has one or more non-currency related contingencies; and