Q–6 Does a commodities dealer or person regularly engaged in investing in regulated futures contracts qualify for the profit presumption for all transactions?

A–6 No. The presumption is only applicable to regulated futures contract transactions in property that is the subject of the person's regular trading activity. For example, a commodities dealer who regularly trades only in agricultural futures will not qualify for the presumption for a silver futures straddle transaction. For purposes of this section, the term ''regulated futures contracts'' has the meaning given to such term by section 1256(b) of the Code as in effect before the enactment of the Tax Reform Act of 1984.

Q–7 Who qualifies as a commodities dealer or as a person regularly engaged in investing in regulated futures contracts for purposes of the profit presumption?

A–7 For purposes of this section, the term ''commodities dealer'' has the meaning given to such term by section 1402(i)(2)(B) of the Code. Section 1402(i)(2)(B) defines a commodities dealer as a person who is actively engaged in trading section 1256 contracts (which includes regulated futures contracts as defined in Q&A–6) and is registered with a domestic board of trade which is designated as a contract market by the Commodity Futures Trading Commission. To determine if a person is regularly engaged in investing in regulated futures contracts all the facts and circumstances should be considered including, but not limited to, the following factors: (1) Regularity of trading at all times throughout the year; (2) the level of transaction costs; (3) substantial volume and economic consequences of trading at all times throughout the year; (4) percentage of time dedicated to commodity trading activities as compared to other activities; and (5) the person's knowledge of the regulated futures contract market.

Q–8 If a commodities dealer or a person regularly engaged in investing in regulated futures contracts participates in a syndicate, as defined in section 1256(e)(3)(B) of the Code, does the rebuttable presumption of ''entered into for profit'' apply to the transactions entered into through the syndicate?

A–8 No. A participant in a syndicate does not qualify for the rebuttable presumption of ''entered into for profit'' with respect to transactions entered into by or for the syndicate. A syndicate is defined in section 1256(e)(3)(B) of the Code as any partnership or other entity (other than a corporation which is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocable to limited partners or limited entrepreneurs (within the meaning of section 464(e)(2)).

Q–9 Will the Service continue to make the closed and completed transaction argument set forth in Rev. Rul. 77–185, 1977–1 C.B. 48, with respect to transactions covered by section 108 of the Act?

A–9 No. The closed and completed transaction argument will not be made regarding transactions subject to section 108 of the Act. In general, losses in such transactions will be allowed for the taxable year of disposition if the transaction is not viewed as a sham and satisfies the ''entered into for profit'' test described in Q&A–2. Nevertheless, for certain positions covered by section 108 of the Act, various Code sections may apply without regard to whether such position constitutes a straddle to disallow or limit the loss otherwise allowable in the year of the disposition. For example, dispositions of certain positions held by a partnership which resulted in a loss to a partner may be limited or disallowed under section 465 of 704(d).

[T.D. 7968, 49 FR 33445, Aug. 23, 1984]

§ 1.166–1 Bad debts.

(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) *Manner of selecting method.* (1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

(2) Taxpayers who have properly selected one of the two methods for treating bad debts under provisions of prior law corresponding to section 166 shall continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method.

(3)(i) For taxable years beginning after December 31, 1959, application for permission to change the method of treating bad debts shall be made in accordance with section 446(e) and paragraph (e)(3) of §1.446–1.

(ii) For taxable years beginning before January 1, 1960, application for permission to change the method of treating bad debts shall be made at least 30 days before the close of the taxable year for which the change is effective.

(4) Nothwithstanding paragraphs (b)(1), (2), and (3) of this section, a dealer in property currently employing the accrual method of accounting and currently maintaining a reserve for bad debts under section 166(c) (which may have included guaranteed debt obligations described in section 166(f)(1)(A)) may establish a reserve for section 166(f)(1)(A) guaranteed debt obligations for a taxable year ending after October 21, 1965 under section 166(f) and §1.166–10 by filing on or before April 17, 1986 an amended return indicating that such a reserve has been established. The establishment of such a reserve will not be considered a change in method of accounting for purposes of section 446(e). However, an election by a taxpayer to establish a reserve for bad debts under section 166(c) shall be treated as a change in method of accounting. See also §1.166–4, relating to reserve for bad debts, and §1.166–10, relating to reserve for guaranteed debt obligations.

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for purposes of the preceding sentence to the extent that the income such debt represents have been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year. For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this pargarph. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt its not due at the time of deduction shall not of itself prevent is allowance under section 166. For the disallowance of deductions for bad debts owed by a political party, see §1.271–1.

(d) *Amount deductible*—(1) *General rule.* Except in the case of a deduction for a reasonable addition to a reserve for bad debts, the basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by §1.1011–1 for determining the loss from the sale or other disposition of property. To determine the allowable deduction in the case of obligations acquired before March 1, 1913, see also paragraph (b) of §1.1053–1.

(2) *Specific cases.* Subject to any provision of section 166 and the regulations thereunder which provides to the contrary, the following amounts are deductible as bad debts:

(i) *Notes or accounts receivable. (a)* If, in computing taxable income, a taxpayer values his notes or accounts receivable at their fair market value when received, the amount deductible

as a bad debt under section 166 in respect of such receivables shall be limited to such fair market value even though it is less than their face value.

(b) A purchaser of accounts receivable which become worthless during the taxable year shall be entitled under section 166 to a deduction which is based upon the price he paid for such receivables but not upon their face value.

(ii) *Bankruptcy claim.* Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted under section 166 as a bad debt.

(iii) *Claim against decedent's estate.* The excess of the amount of the claim over the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate may be considered a worthless debt under section 166.

(e) *Prior inclusion in income required.* Worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction under section 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.

(f) *Recovery of bad debts.* Any amount attributable to the recovery during the taxable year of a bad debt, or of a part of a bad debt, which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of §1.111–1, relating to the recovery of certain items previously deducted or credited. This paragraph shall not apply, however, to a bad debt which was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts.

(g) *Worthless securities.* (1) Section 166 and the regulations thereunder do not apply to a debt which is evidenced by a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. See section 166(e). For provisions allowing the deduction of a loss resulting from the worthlessness of such a debt, see §1.165–5.

(2) The provisions of subparagraph (1) of this paragraph do not apply to any loss sustained by a bank and resulting from the worthlessness of a security described in section 165(g)(2)(C). See paragraph (a) of §1.582–1.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7902, 48 FR 33260, July 21, 1983; T.D. 8071, 51 FR 2479, Jan. 17, 1986]

§1.166–2 Evidence of worthlessness.

(a) *General rule.* In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

(b) *Legal action not required.* Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

(c) *Bankruptcy*—(1) *General rule.* Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.

(2) *Year of deduction.* In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

(d) *Banks and other regulated corporations*—(1) *Worthlessness presumed in year of charge-off.* If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either—