

§ 1.166-8 Losses of guarantors, endorsers, and indemnitors incurred on agreements made before January 1, 1976.

(a) *Noncorporate obligations*—(1) *Deductible as bad debt.* A payment during the taxable year by a taxpayer other than a corporation in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of an obligation issued by a person other than a corporation shall, for purposes of section 166 and the regulations thereunder, be treated as a debt's becoming worthless within the taxable year, if—

(i) The proceeds of the obligation so issued have been used in the trade or business of the borrower, and

(ii) The borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment except for the existence of the guaranty, endorsement, or indemnity, whether or not such obligation has in fact become worthless within the taxable year in which payment is made.

(2) *Nonbusiness debt rule not applicable.* If a payment is treated as a loss in accordance with the provisions of subparagraph (1) of this paragraph, section 166(d), relating to the special rule for losses sustained on the worthlessness of a nonbusiness debt, shall not apply. Accordingly, in each instance the loss shall be deducted under section 166(a)(1) as a wholly worthless debt even though there has been a discharge of only a part of the taxpayer's obligation. Thus, if the taxpayer makes a payment during the taxable year in discharge of only part of his obligation as a guarantor, endorser, or indemnitor, he may treat such payment under section 166(a)(1) as a debt's becoming wholly worthless within the taxable year, provided that he can establish that such part of the borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment and the conditions of subparagraph (1) of this paragraph have otherwise been satisfied.

(3) *Other applicable provisions.* Other provisions of the internal revenue laws relating to bad debts, such as section 111, relating to the recovery of bad debts, shall be deemed to apply to any

payment which, under the provisions of this paragraph, is treated as a bad debt. If the requirements of section 166(f) are not met, any loss sustained by a guarantor, endorser, or indemnitor upon the worthlessness of the debtor's obligation shall be treated under the provisions of law applicable thereto. See, for example, paragraph (b) of this section.

(b) *Corporate obligations.* The loss sustained during the taxable year by a taxpayer other than a corporation in discharge of all of his obligation as a guarantor of an obligation issued by a corporation shall be treated, in accordance with section 166(d) and the regulations thereunder, as a loss sustained on the worthlessness of a nonbusiness debt if the debt created in the guarantor's favor as a result of the payment does not come within the exceptions prescribed by section 166(d)(2) (A) or (B). See paragraph (a)(2) of § 1.166-5.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to the X Bank being wholly worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment during that year.

Example (2). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. In 1956, B pays a part of his obligation to the X Bank but defaults on the remaining part. In 1957, A makes payment to the X Bank, in discharge of part of his obligation as a guarantor, of the remaining unpaid part of B's obligation to the bank, such part of B's obligation then being worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment of the remaining unpaid part of B's obligation.

Example (3). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used for B's personal use. B defaults on his obligation in 1956. A makes payment to the X Bank during

1957 in discharge of his entire obligation as a guarantor, the obligation of B to X Bank being wholly worthless. A may not apply the benefit of section 166(f) to his loss, since the proceeds of B's obligation have not been used in B's trade or business.

Example (4). During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of Y Corporation to the X Bank, the proceeds of the obligation being used in Y Corporation's business. Y Corporation defaults on its obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of Y Corporation to the X Bank being wholly worthless. At no time during 1955 or 1957 is A engaged in a trade or business. For his taxable year 1957, A is entitled to deduct a capital loss in accordance with the provisions of section 166(d) and paragraph (a) (2) of § 1.166-5. He may not apply the benefit of section 166(f) to his loss, since his payment is in discharge of an obligation issued by a corporation.

(d) *Effective date.* This section applies only to losses, regardless of the taxable year in which incurred, on agreements made before January 1, 1976.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979]

§ 1.166-9 Losses of guarantors, endorsers, and indemnitors incurred, on agreements made after December 31, 1975, in taxable years beginning after such date.

(a) *Payment treated as worthless business debt.* This paragraph applies to taxpayers who, after December 31, 1975, enter into an agreement in the course of their trade or business to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor is treated as a business debt becoming worthless in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 (relating to interest) nor section 165 (relating to losses) shall apply with respect to such a payment.

(b) *Payment treated as worthless non-business debt.* This paragraph applies to taxpayers (other than corporations) who, after December 31, 1975, enter into a transaction for profit, but not in the course of their trade or business, to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor is treated as a worthless nonbusiness debt in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 nor section 165 shall apply with respect to such a payment.

(c) *Obligations issued by corporations.* No treatment as a worthless debt is allowed with respect to a payment made by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor of an obligation issued by a corporation if, on the basis of the facts and circumstances at the time the obligation was entered into, the payment constitutes a contribution to capital by a shareholder. The rule of this paragraph (c) applies to payments whenever made (see paragraph (f) of this section).

(d) *Certain payments treated as worthless debts.* A payment in discharge of part or all of taxpayer's agreement to act as guarantor, endorser, or indemnitor of an obligation is to be treated as a worthless debt only if—

(1) The agreement was entered into in the course of the taxpayer's trade or business or a transaction for profit;

(2) There was an enforceable legal duty upon the taxpayer to make the payment (except that legal action need not have been brought against the taxpayer); and

(3) The agreement was entered into before the obligation became worthless (or partially worthless in the case of an agreement entered into in the course of the taxpayer's trade or business). See §§ 1.166-2 and 1.166-3 for rules on worthless and partially worthless debts. For