

**§ 1.817-4**

and assuming no further adjustments to its basis of \$1,000, the gain realized is \$1,200, but due to the application of section 817(b)(2) the amount of gain recognized is \$500, computed as follows:

|  |         |       |
|--|---------|-------|
| Selling price .....  | \$2,200 |       |
| Less: Adjusted basis as of date of sale .....  | 1,000   |       |
|  |         | 1,200 |
| Gain realized .....  |         | 1,200 |
| Fair market value as of 12-31-58 .....   | \$1,800 |       |
| Adjusted basis as of 12-31-58 .....  | 1,000   |       |
|  |         | 800   |
| Excess of fair market value over adjusted basis .....  |         | 800   |
| Less: Excess of gain which would have been recognized on all prior dispositions but for sec. 817(b) over gain recognized on all prior dispositions (\$300 minus \$200) ..... |         | 100   |
|  |         | 700   |
| Gain recognized .....  |         | 500   |

[T.D. 6558, 26 FR 2783, Apr. 4, 1961, as amended by T.D. 6886, 31 FR 8689, June 23, 1966]

**§ 1.817-4 Special rules.**

(a) *Limitation on capital loss carryovers.* Section 817(c) provides that a net capital loss (as defined in section 1222(10)) for any taxable year beginning before January 1, 1959, shall not be taken into account. For any taxable year beginning after December 31, 1958, the provisions of part II, subchapter P, chapter 1 of the Code (relating to the treatment of capital losses) shall be applicable to life insurance companies for purposes of determining the tax imposed by section 802(a) and § 1.802-3 (relating to the imposition of tax in case of capital gains).

(b) *Gain on transactions occurring prior to January 1, 1959.* For purposes of part I, subchapter L, chapter 1 of the Code, section 817(d) provides that:

(1) There shall be excluded from tax any gain from the sale or exchange of a capital asset, and any gain considered as gain from sale or exchange of a capital asset, which results from sales or other dispositions of property prior to January 1, 1959; and

(2) Any gain after December 31, 1958, resulting from the sale or other disposition of property prior to January 1, 1959, which, but for this subparagraph would be taken into account under section 1231, shall not be taken into account under section 1231.

For example, if a life insurance company makes an installment sale of a capital asset prior to January 1, 1959,

and payments are received after such date, any capital gain attributable to such sale shall not be taken into account for purposes of section 802(a). Furthermore, any gain referred to in subparagraphs (1) and (2) and the preceding sentence shall not be taken into account in determining the excess of the net short-term capital gain over the net long-term capital loss (and for taxable years beginning after December 31, 1961, the excess of the net long-term capital gain over the net short-term capital loss) for purposes of computing taxable investment income under section 804(a)(2) or gain or loss from operations under section 809(b).

(c) *Certain reinsurance transactions in 1958.* For purposes of part I, section 817(e) provides that where a life insurance company reinsures (or sells) all of its insurance contracts of a particular type, such as an entire industrial department, in either a single transaction, or in a series of related transactions, all of which occurred during 1958, and the reinsuring (or purchasing) company or companies assume all liabilities under such contracts, such reinsurance (or sale) shall be treated as the sale of a capital asset. However, such transaction shall be subject to the provisions of section 806(a) and § 1.806-3 (relating to adjustments for certain changes in reserves and assets).

(d) *Certain other reinsurance transactions.* (1) For any taxable year beginning after December 31, 1958, the reinsurance of all or a part of the insurance contracts of a particular type by a life insurance company, in either a single transaction, or in a series of related transactions, occurring in any such taxable year, whereby the reinsuring company or companies assume all liabilities under such contracts, shall not be treated as the sale or exchange of a capital asset but shall be subject to the provisions of section 806(a) and 809 and the regulations thereunder. However, if in connection with a transaction described in the preceding sentence the reinsured or reinsurer transfers an asset which is a capital asset within the meaning of section 1221 (as modified by section 817(a)(2)), such transfer shall be treated as the sale or exchange of a capital asset by the transferor.

(2)(i) The consideration paid by the reinsured to the reinsurer in connection with a transaction described in subparagraph (1) of this paragraph shall be treated as an item of deduction under section 809(d)(7). However any amount received by the reinsured from the reinsurer shall be applied against and reduce (but not below zero) the amount of such consideration, and to the extent that it exceeds such consideration, shall be treated as an item of gross amount under section 809(c)(3).

(ii) In connection with an assumption reinsurance (as defined in paragraph (a)(7)(ii) of § 1.809-5) transaction, a reinsurer shall in any taxable year beginning after December 31, 1957:

(A) Treat the consideration received from the reinsured in any such taxable year as an item of gross amount under section 809(c)(1), and

(B) Treat any amount paid to the reinsured for the purchase of such contracts, to the extent such amount meets the requirements of section 162, as a deferred expense that may be amortized over the reasonably estimated life (as defined in paragraph (d)(2)(iv) of this section) of the contracts reinsured and treat the portion of the expense so amortized in each taxable year as a deduction under section 809(d)(12) irrespective of the taxable year in which such amount was paid to the reinsured.

(iii) For purposes of paragraph (d)(2)(ii) of this section where the reinsured transfers to the reinsurer in connection with the assumption reinsurance transaction a net amount which is less than the increase in the reinsurer's reserves resulting from the transaction, the reinsurer shall be treated as:

(A) Having received from the reinsured consideration in an amount equal to the net amount of the increase in the reinsurer's reserves resulting from the transaction, and

(B) Having paid the reinsured an amount for the purchase of the contracts equal to the excess of the amount of such increase in the reinsurer's reserves over the net amount received from the reinsured.

(iv) For purposes of this subparagraph, the term *reasonably estimated life* means the period during which the contract reinsured remains in force. Such

period shall be based on the facts in each case (such as age, health, and sex of the insured, type of contract reinsured, etc.) and the assuming company's experience (such as mortality, lapse rate, etc.) with similar risks.

(3) The provisions of this paragraph may be illustrated by the following examples:

*Example 1.* On June 30, 1959, X, a life insurance company, reinsured a portion of its insurance contracts with Y, a life insurance company, under an agreement whereby Y agreed to assume and to become solely liable under the contracts reinsured. The reserves on the contracts reinsured by X were \$100,000. Under the reinsurance agreement X agreed to pay Y \$100,000 for assuming such contracts and Y agreed to pay X \$17,000 for the right to receive future premium payments under this block of contracts. Rather than exchange payments of money, X agreed to pay Y a net amount of \$83,000 in cash. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, that there are no other insurance transactions by X or Y during the taxable year, and assuming that X and Y compute the reserves on the contracts reinsured on the same basis, X has income of \$100,000 under section 809(c)(2) as a result of the net decrease in its reserves. X has a net deduction of \$83,000 (\$100,000 - \$17,000) under section 809(d)(7). For the taxable year 1959, Y has income of \$100,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of \$100,000 under section 809(d)(2) for the net increase in reserves and \$1,000 (\$17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining \$16,000 shall be amortized over the next 16 succeeding taxable years ( $16 \times \$1,000 = \$16,000$ ) under section 809(d)(12) at the rate of \$1,000 for each such taxable year.

*Example 2.* The facts are the same as in example 1, except X agreed to pay Y a consideration of \$100,000 in cash for assuming these contracts and Y paid X a bonus of \$17,000 in cash and that this bonus meets the requirements of section 162. Assuming that the reasonably estimated life of the contracts reinsured is 17 years, X has income of \$100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of \$83,000 under section 809(d)(7) for the amount of the consideration (\$100,000) paid to Y for assuming these contracts, reduced by the bonus (\$17,000) received from Y. For the taxable year 1959, Y has income of \$100,000 under section 809(c)(1) as a result of the consideration received from X and deductions of \$100,000 under section 809(d)(2) for the net increase in reserves and \$1,000 (the bonus of

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\$17,000 divided by 17, the reasonably estimated life of the contracts reinsured), under section 809(d)(12). The remaining amount of the bonus (\$16,000) shall be amortized over the next 16 succeeding taxable years (16×\$1,000=\$16,000) under section 809(d)(12) at the rate of \$1,000 for each such taxable year.

*Example 3.* The facts are the same as in Example 1, except that the reinsurance agreement does not specifically provide that X agreed to pay Y \$100,000 for assuming the contracts reinsured and Y agreed to pay X \$17,000 for the right to receive future premium payments under such contracts. Instead, X agreed to pay Y a net amount of \$83,000 in cash for assuming such contracts. Nevertheless, Y is treated as having received from X consideration equal to \$100,000, the amount of the increase in Y's reserves, and as having paid \$17,000 (\$100,000 less \$83,000) for the purchase of such contracts. Therefore, for the taxable year 1959, Y has income of \$100,000 under section 809(c)(1). Y also has a deduction of \$100,000 under section 809(d)(2) for the net increase in its reserves and an amortization deduction under section 809(d)(12) of \$1,000 (\$17,000 divided by 17, the reasonably estimated life of the contracts reinsured). The remaining \$16,000 shall be amortized by Y over the next 16 succeeding years at the rate of \$1,000 for each such year. For 1959, X has income of \$100,000 under section 809(c)(2) as a result of the net decrease in its reserves and a deduction of \$83,000 under section 809(d)(7) for the net amount of consideration paid to Y for assuming the contracts reinsured.

*Example 4.* The facts are the same as in example 1, except that X agreed to pay Y a consideration of \$130,000 in cash for assuming such contracts. Based upon these facts, X has income of \$100,000 under section 809(c)(2) as a result of this net decrease in its reserves and a deduction of \$130,000 under section 809(d)(7) for the amount of the consideration paid to Y for assuming these contracts. Y has income of \$130,000 under section 809(c)(1) as a result of the consideration received from X and a deduction of \$100,000 under section 809(d)(2) for the net increase in its reserves.

*Example 5.* On August 1, 1960, R, a life insurance company, reinsured all of its insurance policies with S, a life insurance company, under an agreement whereby S agreed to assume and become solely liable under the contracts reinsured. The reserves on the contracts reinsured by R were \$3,000,000. Under the reinsurance agreement, R agreed to pay S a consideration of \$3,000,000 in stocks and bonds for assuming such contracts. Assuming no other insurance transactions by R or S during the taxable year, that R and S compute the reserves on the contracts reinsured on the same basis, and that R has a recognized gain (after the application of the limitation of section 817(b)(1)) of \$20,000 due to appreciation in value of the assets trans-

ferred, the results to each company are as follows:

|  |             |
|--|-------------|
| Company R (reinsured)  |             |
| Net decrease in reserves (sec. 809(c) (2)) .....   | \$3,000,000 |
| Capital gain (as limited by sec. 817(b) (1)) to be taxed separately under sec. 802(a)(2) .....                         | 20,000      |
| Consideration paid by R to S in respect of S's assuming liabilities under contracts issued by R (sec. 809(d)(7)) ..... | \$3,000,000 |
| INCOME   |             |
| Company S (reinsurer)  |             |
| Consideration received by S in respect of assuming liabilities under contracts issued by R (sec. 809(c)(1)) .....      | \$3,000,000 |
| DEDUCTIONS   |             |
| Net increase in reserves (sec.809(d)(2)) .....   | \$3,000,000 |

[T.D. 6558, 26 FR 2783, Apr. 4, 1961, as amended by T.D. 6625, 27 FR 12543, Dec. 19, 1962; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 41 FR 5100, Feb. 4, 1976]

**§ 1.817-5 Diversification requirements for variable annuity, endowment, and life insurance contracts.**

(a) *Consequences of nondiversification—(1) In general.* Except as provided in paragraph (a)(2) of this section, for purposes of subchapter L, section 72, and section 7702(a), a variable contract (as defined in section 817(d)), other than a pension plan contract (as defined in section 818(a)), which is based on one or more segregated asset accounts shall not be treated as an annuity, endowment, or life insurance contract for any calendar quarter period for which the investments of any such account are not adequately diversified. For this purpose, a variable contract shall be treated as based on a segregated asset account for a calendar quarter period if amounts received under the contract (or earnings thereon) are allocated to the segregated asset account at any time during the period. In addition, a variable contract that is not treated as an annuity, endowment, or life insurance contract for any period by reason of this paragraph (a)(1) shall not be treated as an annuity, endowment, or life insurance contract for any subsequent period even if the investments are adequately diversified for such subsequent period. If a variable contract which is a life insurance or endowment contract under other applicable (e.g., State or foreign) law is not treated as a life insurance or endowment contract under section 7702(a), the income on the contract for any taxable year of the policyholder is treated as ordinary income received or