

Internal Revenue Service, Treasury

§ 1.817-2

	1959	1960	1961	1962
Added by reason of election under sec. 815(d)(1)	0	0	0
Subtracted (distributions)	0	40.00	40.00
Policyholders surplus account—				
At beginning of year	0	0	10.00	20.00
Added for year	0	10.00	10.00
Subtracted (distributions)	0	0	0
Subtracted (by reason of election under sec. 815(d)(1))	0	0	0
Tax base (sec. 802(b)(3))	0	0	0
Tax (sec. 802(b)(3) base)	0	0	0

As a result of the loss from operations for 1962, the election under section 815(d)(1) for the taxable year 1959 has become inapplicable in its entirety since the balance in the policyholders surplus account at the end of 1959, as recomputed, is zero. Thus, S would be entitled to a total refund of \$7.50 for the taxable year 1959. Of this amount, \$4.50 is due to the recomputation of the section 802(b)(1) and (2) tax base and \$3 to the amount of tax paid by reason of the election under section 815(d)(1).

[T.D. 6535, 26 FR 545, Jan. 20, 1961]

MISCELLANEOUS PROVISIONS

§ 1.817-1 Taxable years affected.

Except as otherwise provided therein, §§ 1.817-2 through 1.817-4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112) and section 3 of the Act of October 23, 1962 (76 Stat. 1134).

[T.D. 6886, 31 FR 8689, June 23, 1966]

§ 1.817-2 Treatment of capital gains and losses.

(a) *In general.* For taxable years beginning after December 31, 1958, and before January 1, 1962, if the net long-term capital gain (as defined in section 1222(7)) of any life insurance company exceeds its net short-term capital loss (as defined in section 1222(6)), section 802(a)(2) prior to its amendment by section 3 of the Act of October 23, 1962 (76 Stat. 1134), imposes a separate tax

equal to 25 percent of such excess. For taxable years beginning after December 31, 1961, if the net long-term capital gain of any life insurance company exceeds its net short-term capital loss, section 802(a)(2) imposes an alternative tax in lieu of the tax imposed by section 802(a)(1), if and only if such alternative tax is less than the tax imposed by section 802(a)(1). Except as modified by section 817 (rules relating to certain gains and losses), the general rules of the Code relating to gains and losses, such as subchapter O (relating to gain or loss on disposition of property), subchapter P (relating to capital gains and losses), etc., shall apply with respect to life insurance companies.

(b) *Modification of section 1221 and 1231.* (1) In the case of a life insurance company, section 817(a)(1) provides that for purposes of applying section 1231(a) (relating to property used in the trade or business and involuntary conversions), the term *property used in the trade or business* shall be treated as including only:

(i) Property used in carrying on an insurance business, of a character subject to the allowance for depreciation under section 167 (even though fully depreciated), held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977), and real property used in carrying on an insurance business, held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977), and which is not:

(a) Property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year;

(b) Property held by the taxpayer primarily for sale to customers in the ordinary course of business; or

(c) A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by a taxpayer described in section 1221(3). In the case of a letter, memorandum, or property similar to a letter or memorandum, this subdivision (c) applies only to sales and other dispositions occurring after July 25, 1969.

(ii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a

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sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(2) In the case of a life insurance company, section 817(a)(2) provides that for purposes of applying section 1221(2) (relating to the exclusion of certain property from the term capital asset), the reference to property used in trade or business shall be treated as including only property used in carrying on an insurance business.

(3) Section 1231(a), as modified by section 817(a)(1) and subparagraph (1) of this paragraph, shall apply to recognized gains and losses from the following:

(i) The sale, exchange, or involuntary conversion of the following property, if held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977):

(a) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(b) Furniture and equipment owned by the life insurance company and used in the home office and branch office buildings occupied by the life insurance company; and

(c) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(ii) The involuntary conversion of capital assets held for more than 1 year (6 months for taxable years beginning before 1977; 9 months taxable years beginning in 1977).

(iii) The cutting or disposal of timber, or the disposal of coal or iron ore, to the extent considered arising from a sale or exchange by reason of the provisions of section 631 and the regulations thereunder.

(4) Section 1221(2), as modified by section 817(a)(2) and subparagraph (2) of this paragraph, shall include only the following property:

(i) The home office and branch office buildings (including land) owned and occupied by the life insurance company;

(ii) Furniture and equipment owned by the life insurance company and used

in the home office and branch office buildings occupied by the life insurance company; and

(iii) Automobiles and other depreciable personal property used in connection with the operations conducted in the home office and branch office buildings occupied by the life insurance company.

(5) If an asset described in subparagraph (3) (i)(a), (b), or (c) or subparagraph (4) of this paragraph, or any portion thereof, is also an "investment asset" (an asset from which gross investment income, as defined in section 804(b), is derived), such asset, or portion thereof, shall not be treated as an asset used in carrying on an insurance business. Accordingly, the gains or losses from the sale or exchange (or considered as from the sale or exchange) of depreciable assets attributable to any trade or business, other than the insurance trade or business, carried on by the life insurance company, such as operating a radio station, housing development, or a farm, or renting various pieces of real estate shall be treated as gains or losses from the sale or exchange of a capital asset unless such asset is involuntarily converted (within the meaning of paragraph (e) of § 1.123-1).

(c) *Illustration of principles.* The provisions of section 817(a) and this section may be illustrated by the following examples:

Example 1. L, a life insurance company, has recognized gains and losses for the taxable year 1959 from the sale or involuntary conversion of the following items:

	Gains	Losses
Stocks, held for more than 6 months	\$100,000	
Bonds, held for more than 6 months		\$5,000
Housing development, held for more than 6 months		400,000
Branch office building owned and occupied by L, held for more than 6 months		115,000
Furniture and equipment used in the investment department, held for more than 6 months	30,000	
Radio station, held for more than 6 months	200,000	
Involuntary conversion of apartment building, held for more than 6 months	7,000	

The recognized gains and losses from the sale of the stocks, bonds, housing development,

and radio station shall be treated as gains and losses from the sale of capital assets since such items are capital assets within the meaning of section 1221 (as modified by section 817(a)(2)). Accordingly, the provisions of section 1231 shall not apply to the sale of such capital assets. However, the provisions of section 1231 (as modified by section 817(a)(1)) shall apply to the sale of the branch office building and the furniture and equipment, and the apartment building involuntarily converted. Since the aggregate of the recognized losses (\$115,000) exceeds the aggregate of the recognized gains (\$37,000), the gains and losses are treated as ordinary gains and losses.

Example 2. Y, a life insurance company, owns a twenty-story home office building, having an adjusted basis of \$15,000,000, ten floors of which it rents to various tenants, one floor of which is utilized by it in operating its investment department, and the remaining nine floors of which are occupied by it in carrying on its insurance business. If in 1960, Y sells the building for \$10,000,000, Y must first apportion its basis between that portion of the building (one-half) used in carrying on an insurance business, and that portion of the building (one-half) classified as an "investment asset", before it can determine the character of the loss attributable to each portion of the building. For such purpose, the one floor utilized by Y in operating its investment department is treated as used in carrying on an insurance business. Assuming that each portion of the building bears an equal (one-half) relation to the basis of the entire building, Y (without regard to section 817(b)) would have a \$2,500,000 ordinary loss on that portion used in carrying on an insurance business (assuming that Y had no gains subject to section 1231), and a \$2,500,000 capital loss on that portion of the building classified as an investment asset.

[T.D. 6558, 26 FR 2782, Apr. 4, 1961, as amended by T.D. 6841, 30 FR 9308, July 27, 1965; T.D. 6886, 31 FR 8689, June 23, 1966; T.D. 7369, 40 FR 29840, July 16, 1975; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.817-3 Gain on property held on December 31, 1958, and certain substituted property acquired after 1958.

(a) *Limitation on gain recognized on property held on December 31, 1958.* (1) Section 817(b)(1) limits the amount of gain that shall be recognized on the sale or other disposition of property other than insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property) if:

(i) The property was held (or treated as held within the meaning of paragraph (c)(1) of this section) by a life insurance company on December 31, 1958;

(ii) The taxpayer has been a life insurance company at all times on and after December 31, 1958, including the date of the sale or other disposition of the property; and

(iii) The fair market value of the property on December 31, 1958, exceeds the adjusted basis for determining gain as of such date.

The gain on the sale or other disposition of such property shall be limited to an amount (but not less than zero) equal to the amount by which the gain (determined without regard to section 817(b)(1)) exceeds the difference between fair market value of such property on December 31, 1958, and the adjusted basis for determining gain as of such date. Accordingly, the tax imposed under section 802(a) shall apply with respect to the amount of gain so limited. In addition, in the case of a stock life insurance company, the amount of such gain shall be taken into account under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to the shareholders surplus account (as defined in section 815(b) and § 1.815-3) for the taxable year. Furthermore, the amount of the gain (determined without regard to section 817(b)(1) and this paragraph) which is not taken into account under section 802(a) and under paragraph (f) of § 1.802-3 by reason of the application of section 817(b)(1) shall be included in other accounts (as defined in § 1.815-5) by such a company for the taxable year.

(2) Section 817(b)(1) and subparagraph (1) of this paragraph shall not apply for purposes of determining loss with respect to property held on December 31, 1958.

(b) *Illustration of principles.* The application of section 817(b)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example 1. On December 31, 1958, J, a stock life insurance company, owned stock of Z Corporation and on such date the stock had an adjusted basis for determining gain of \$5,000 and a fair market value of \$6,000. On August 1, 1959, the company sells such stock

for \$8,000. Assuming J qualifies as a life insurance company for the taxable year 1959, and applying the provisions of section 817(b)(1) and paragraph (a) of this section, the gain recognized (assuming no adjustment to basis for the period since December 31, 1958) on the sale shall be limited to \$2,000 (the amount by which the gain realized, \$3,000, exceeds the difference, \$1,000, between the fair market value, \$6,000, and the adjusted basis, \$5,000, for determining gain on December 31, 1958). Thus, J shall take into account \$2,000 under section 815(b)(2)(A)(ii) for purposes of determining the amount to be added to its shareholders surplus account for the taxable year and shall include \$1,000 in other accounts for the taxable year.

Example 2. The facts are the same as in example 1, except that the selling price is \$5,800. In such case, no gain shall be recognized even though there is a realized gain of \$800 since such realized gain does not exceed the difference (\$1,000) between the fair market value (\$6,000) and the adjusted basis (\$5,000) for determining gain on December 31, 1958. Furthermore, no loss shall be realized or recognized as a result of this transaction. Thus, J shall include \$800 in other accounts for the taxable year and shall not take into account any amount under section 815(b)(2)(A)(ii).

Example 3. The facts are the same as in example 1, except that the adjusted basis for determining loss is \$5,000 and the selling price is \$4,500. In such case, since J has sustained a loss, section 817(b)(1) does not apply.

(c) *Certain substituted property acquired after December 31, 1958.* Section 817(b)(2) provides that if a life insurance company acquires property after December 31, 1958, in exchange for property actually held by the company on December 31, 1958, and the property acquired has a substituted basis within the meaning of section 1016(b) and § 1.1016-10, the following rules shall apply:

(1) For purposes of section 817(b)(1), such acquired property shall be deemed as having been held continuously by the taxpayer since the beginning of the holding period thereof as determined under section 1223;

(2) The fair market value and adjusted basis referred to in section 817(b)(1) shall be that of that property for which the holding period taken into account includes December 31, 1958;

(3) Section 817(b)(1) shall apply only if the property or properties, the holding periods of which are taken into account, were held only by life insurance companies after December 31, 1958, dur-

ing the holding periods so taken into account;

(4) The difference between the fair market value and adjusted basis referred to in section 817(b)(1) shall be reduced (but not below zero) by the excess of (i) the gain that would have been recognized but for section 817(b) on all prior sales or other dispositions after December 31, 1958, of properties referred to in section 817(b)(2)(C) over (ii) the gain that was recognized on such sales or other dispositions; and

(5) The basis of such acquired property shall be determined as if the gain which would have been recognized but for section 817(b) were recognized gain.

For purposes of section 817(b)(2) and this paragraph, the term *property* does not include insurance and annuity contracts (and contracts supplementary thereto) and property described in section 1221(1) (relating to stock in trade or inventory-type property). Furthermore, the provisions of section 817(b)(1) and paragraph (a)(1) of this section shall not apply for purposes of determining loss with respect to property described in section 817(b)(2) and this paragraph.

(d) *Illustration of principles.* The application of section 817(b)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume that W, a life insurance company, owns property B on December 31, 1958, at which time its adjusted basis was \$1,000 and its fair market value was \$1,800. On January 31, 1960, in a transaction to which section 1031 (relating to exchange of property held for productive use or investment) applies, W receives property H having a fair market value of \$1,700 plus \$300 in cash in exchange for property B. The gain realized on the transaction, without regard to section 817(b) is \$1,000 (assuming no adjustments to basis for the period since December 31, 1958). Under the provisions of section 817(b)(1) the gain is limited to \$200. The entire \$200 shall be recognized since such amount is less than the amount of gain (\$300) which would be recognized under section 1031. Applying the provisions of section 817(b)(2) and paragraph (c) of this section, the basis of property H shall be determined as if the entire \$300 of cash received is recognized gain. Thus, the basis of property H under section 1031 is \$1,000 (\$1,000 (the basis of property B) minus \$300 (the amount of money received) plus \$300 (the recognized gain of \$200 plus \$100 which would have been recognized but for section 817(b))). If W later sells property H for \$2,200 cash,

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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

\$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

accrued by the policyholder during such year in accordance with section 7702 (g) and (h). Likewise, if a variable contract is not treated as an annuity contract under section 72, the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the policyholder during such year in the same manner as a life insurance or endowment contract under section 7702 (g) and (h).

(2) *Inadvertent failure to diversify.* The investments of a segregated asset account shall be treated as satisfying the requirements of paragraph (b) of this section for one or more periods, provided the following conditions are satisfied—

(i) The issuer or holder must show the Commissioner that the failure of the investments to satisfy the requirements of paragraph (b) of this section for such period or periods was inadvertent,

(ii) The investments of the account must satisfy the requirements of paragraph (b) of this section within a reasonable time after the discovery of such failure, and

(iii) The issuer or holder of the variable contract must agree to make such adjustments or pay such amounts as may be required by the Commissioner with respect to the period or periods during which the investments of the account did not satisfy the requirements of paragraph (b) of this section.

(b) *Diversification of investments—(1) In general.* (i) Except as otherwise provided in this paragraph and paragraph (c) of this section, the investments of a segregated asset account shall be considered adequately diversified for purposes of this section and section 817(h) only if—

(A) No more than 55% of the value of the total assets of the account is represented by any one investment;

(B) No more than 70% of the value of the total assets of the account is represented by any two investments;

(C) No more than 80% of the value of the total assets of the account is represented by any three investments; and

(D) No more than 90% of the value of the total assets of the account is represented by any four investments.

(ii) For purposes of this section—

(A) All securities of the same issuer, all interests in the same real property project, and all interests in the same commodity are each treated as a single investment; and

(B) In the case of government securities, each government agency or instrumentality shall be treated as a separate issuer.

(iii) See paragraph (f) of this section for circumstances in which a segregated asset account is treated as the owner of assets held indirectly through certain pass-through entities and corporations taxed under subchapter M, chapter 1 of the Code.

(2) *Safe harbor.* A segregated asset account will be considered adequately diversified for purposes of this section and section 817(h) if—

(i) The account meets the requirements of section 851 (b)(4) and the regulations thereunder; and

(ii) No more than 55% of the value of the total assets of the account is attributable to cash, cash items (including receivables), government securities, and securities of other regulated investment companies.

(3) *Alternative diversification requirements for variable life insurance contracts.* (i) A segregated asset account with respect to variable life insurance contracts will be considered adequately diversified for purposes of this section and section 817(h) if the requirements of paragraph (b)(1) or (b)(2) of this section are satisfied or if the assets of such account, other than Treasury securities, satisfy the percentage limitations prescribed in paragraph (b)(1) of this section increased by the product of (A) .5 and (B) the percentage of the value of the total assets of the account that is represented by Treasury securities. In determining whether the assets of an account, other than Treasury securities, satisfy the increased percentage limitations, such limitations are applied as if the Treasury securities were not included in the account (*i.e.*, the increased percentage limitations are not applied to Treasury securities and the value of the total assets of the account is reduced by the value of the Treasury securities).

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

Example 1. On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of \$100,000. The assets of the account are represented by Treasury securities having a total value of \$90,000 and securities of Corporation A having a total value of \$10,000. The 55% limit described in paragraph (b)(1)(i) of this section would be increased by 45% (0.5×90%) to 100%, and would then be applied to the assets of the account other than Treasury securities. Because no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporation A, the investments of the account will be considered adequately diversified.

Example 2. On the last day of a quarter of a calendar year, a segregated asset account with respect to variable life insurance contracts holds assets having a total value of \$100,000. The assets of the account are represented by Treasury securities having a total value of \$60,000, securities of Corporation A having a total value of \$30,000, and securities of Corporation B having a total value of \$10,000. The 55% and 70% limits described in paragraph (b)(1)(i) of this section would be increased by 30% (0.5×60%) to 85% and 100%, respectively, and would then be applied to the assets of the account other than Treasury securities. Securities of Corporation A represent 75%, and securities of Corporation B represent 25%, of the value of the assets of the account other than Treasury securities. Because no more than 85% of the value of the assets other than Treasury securities is represented by securities of Corporation A or B and no more than 100% of the value of the assets other than Treasury securities is represented by securities of Corporations A and B, the investments of the account will be considered adequately diversified.

(c) *Periods for which an account is adequately diversified*—(1) *In general.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the last day of a quarter of a calendar year (*i.e.*, March 31, June 30, September 30, and December 31) or within 30 days after such last day shall be considered adequately diversified for such quarter.

(2) *Start-up period.* (i) Except as provided in paragraph (c)(2)(iv) of this section, a segregated asset account that is not a real property account on its first anniversary shall be considered adequately diversified until such first anniversary.

(ii) Except as provided in paragraph (c)(2)(iv) of this section, a segregated

asset account that is a real property account on its first anniversary shall be considered adequately diversified until the earlier of its fifth anniversary or the anniversary on which the account ceases to be a real property account.

(iii) For purposes of paragraph (c)(2)(i) and (ii) of this section, the anniversary of a segregated asset account is the anniversary of the date on which any amount received under a life insurance or annuity contract, other than a pension plan contract (as defined in section 818 (a)), is first allocated to the account.

(iv) If more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than one year before such date, paragraph (c)(2)(i) of this section shall not apply to the segregated asset account for any period after such date. Similarly, if more than 30 percent of the amount allocated to a segregated asset account as of the last day of a calendar quarter is attributable to contracts entered into more than 5 years before such date, paragraph (c)(2)(ii) of this section shall not apply to the segregated asset account for any period after such date. For purposes of this paragraph (c)(2), amounts transferred to the account from a diversified account (determined without regard to this paragraph (c)(2)) or as a result of an exchange pursuant to section 1035 in which the issuer of the contract received in the exchange is not related in a manner specified in section 267(b) to the issuer of the contract transferred in the exchange are not treated as—

(A) Amounts attributable to contracts entered into more than one year before such date, in the case of accounts subject to paragraph (c)(2)(i) of this section, or

(B) Amounts attributable to contracts entered into more than five years before such date, in the case of accounts subject to paragraph (c)(2)(ii) of this section.

(3) *Liquidation period.* A segregated asset account that satisfies the requirements of paragraph (b) of this section on the date a plan of liquidation is

adopted shall be considered adequately diversified for—

(i) The one-year period beginning on the date the plan of liquidation is adopted if the account is not a real property account on such date; or

(ii) The two-year period beginning on the date the plan of liquidation is adopted if the account is a real property account on such date.

(d) *Market fluctuations.* A segregated asset account that satisfies the requirements of paragraph (b) of this section at the end of any calendar quarter (or within 30 days after the end of such calendar quarter) shall not be considered nondiversified in a subsequent quarter because of a discrepancy between the value of its assets and the diversification requirements unless such discrepancy exists immediately after the acquisition of any asset and such discrepancy is wholly or partly the result of such acquisition.

(e) *Segregated asset account.* For purposes of section 817(h) and this section, a segregated asset account shall consist of all assets the investment return and market value of each of which must be allocated in an identical manner to any variable contract invested in any of such assets. See paragraph (g) for examples illustrating the application of this paragraph (e).

(f) *Look-through rule for assets held through certain investment companies, partnerships, or trusts—(1) In general.* If this paragraph (f) applies, a beneficial interest in a regulated investment company, a real estate investment trust, a partnership, or a trust that is treated under sections 671 through 679 as owned by the grantor or another person (“investment company, partnership, or trust”) shall not be treated as a single investment of a segregated asset account. Instead, a pro rata portion of each asset of the investment company, partnership, or trust shall be treated, for purposes of this section, as an asset of the segregated asset account. For purposes of this section, the ratable interest of a partner in a partnership’s assets shall be determined in accordance with the partner’s capital interest in the partnership.

(2) *Applicability—(i) Certain investment companies, partnerships, and trusts.* This paragraph (f) shall apply to an invest-

ment company, partnership, or trust if—

(A) All the beneficial interests in the investment company, partnership, or trust (other than those described in paragraph (f)(3) of this section) are held by one or more segregated asset accounts of one or more insurance companies; and

(B) Public access to such investment company, partnership, or trust is available exclusively (except as otherwise permitted in paragraph (f)(3) of this section) through the purchase of a variable contract. Solely for this purpose, the status of a contract as a variable contract will be determined without regard to section 817(h) and this section.

(ii) *Trusts holding Treasury securities.* This paragraph (f) shall also apply to a trust that is treated under section 671 through 679 as owned by the grantor or another person if substantially all of the assets of the trust are represented by Treasury securities.

(3) *Interests not held by segregated asset accounts.* Satisfaction of the requirements of paragraph (f)(2)(i) of this section shall not be prevented by reason of beneficial interests in the investment company, partnership, or trust that are—

(i) Held by the general account of a life insurance company or a corporation related in a manner specified in section 267(b) to a life insurance company, but only if the return on such interests is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), there is no intent to sell such interests to the public, and a segregated asset account of such life insurance company also holds or will hold a beneficial interest in the investment company, partnership, or trust;

(ii) Held by the manager, or a corporation related in a manner specified in section 267(b) to the manager, of the investment company, partnership, or trust, but only if the holding of the interests is in connection with the creation or management of the investment company, partnership, or trust,

the return on such interest is computed in the same manner as the return on an interest held by a segregated asset account is computed (determined without regard to expenses attributable to variable contracts), and there is no intent to sell such interests to the public;

(iii) Held by the trustee of a qualified pension or retirement plan;

(iv) Held by a qualified tuition program as defined in section 529;

(v) Held by the trustee of a pension plan established and maintained outside of the United States, as defined in section 7701(a)(9), primarily for the benefit of individuals substantially all of whom are nonresident aliens, as defined in section 7701(b)(1)(B);

(vi) Held by an account which, pursuant to Puerto Rican law or regulation, is segregated from the general asset accounts of the life insurance company that owns the account, provided the requirements of section 817(d) and (h) are satisfied. Solely for purposes of this paragraph (f)(3)(vi), the requirement under section 817(d)(1) that the account be segregated pursuant to State law or regulation shall be disregarded and § 1.817-5(f)(1) shall be applied without regard to the Puerto Rican segregated asset account; or

(vii) Held by the public, or treated as owned by policyholders pursuant to Rev. Rul. 81-225, 1981-2 C.B. 12, but only if (A) the investment company, partnership, or trust was closed to the public in accordance with Rev. Rul. 82-55, 1982-1 C.B. 12, or (B) all the assets of the segregated asset account are attributable to premium payments made by policyholders prior to September 26, 1981, to premium payments made in connection with a qualified pension or retirement plan, or to any combination of such premium payments.

(g) *Examples.* The provisions of paragraphs (e) and (f) of this section may be illustrated by the following examples.

Example 1. (i) The assets underlying variable contracts issued by a life insurance company consist of two groups of assets: (a) a diversified portfolio of debt securities and (b) interests in P, a partnership. All of the beneficial interests in P are held by one or more segregated asset accounts of one or more insurance companies and public access to P is available exclusively through the purchase of a variable contract. The variable

contracts provide that policyholders may specify which portion of each premium is to be invested in the debt securities and which portion is to be invested in P interests. The portfolio of debt securities and the assets of P, considered separately, each satisfy the diversification requirements of paragraph (b) of this section.

(ii) As a result of the ability of policyholders to allocate premiums among the two groups of assets, the investment return and market value of the interests in P and the debt securities may be allocated to different variable contracts in a non-identical manner. Accordingly, under paragraph (e) of this section, the interests in P are treated as part of a single segregated asset account ("Account 1") and the debt securities are treated as part of a different segregated asset account ("Account 2").

(iii) Since P is described in paragraph (f)(2)(i) of this section, interests in P will not be treated as a single investment of Account 1. Rather, Account 1 is treated as owning a pro rata portion of the assets of P.

(iv) Since Account 1 and Account 2 each satisfy the requirements of paragraph (b) of this section, variable contracts that are based on either or both accounts are treated as annuity, endowment, or life insurance contracts.

Example 2. The facts are the same as in example 1 except that some of the beneficial interests in P are held by persons not described in paragraph (f)(3) of this section. Since P is not described in paragraph (f)(2) of this section, interests in P will be treated as a single investment of Account 1. As a result, Account 1 does not satisfy the requirements of paragraph (b) of this section. Variable contracts based in whole or in part on Account 1 are not treated as annuity, endowment, or life insurance contracts. Variable contracts that are not based on Account 1 at any time during the period in which such account fails to satisfy the requirements of paragraph (b) of this section (*i.e.*, contracts based entirely on Account 2), are treated as annuity, endowment, or life insurance contracts. See paragraph (a)(1).

Example 3. The facts are the same as in example 2 except that the variable contracts do not permit policyholders to allocate premiums between or among the debt securities and interests in P. Thus, the investment return and market value of the interests in P and the debt securities must be allocated to the same variable contracts and in an identical manner. Under paragraph (e) of this section, the interests in P and the debt securities are treated as part of a single segregated asset account. If the interests in P and the debt securities, considered together, satisfy the requirements of paragraph (b) of

this section, contracts based on this segregated asset account will be treated as annuity, endowment, or life insurance contracts.

(h) *Definitions.* The terms defined below shall, for purposes of this section, have the meanings set forth in such definitions:

(1) *Government security*—(i) *General rule.* The term *government security* shall mean any security issued or guaranteed or insured by the United States or an instrumentality of the United States; or any certificate of deposit for any of the foregoing. Any security or certificate or deposit insured or guaranteed only in part by the United States or an instrumentality thereof is treated as issued by the United States or its instrumentality only to the extent so insured or guaranteed, and as issued by the direct obligor to the extent not so insured or guaranteed. For purposes of this paragraph (h)(1), an instrumentality of the United States shall mean any person that is treated for purposes of 15 U.S.C. 80a-2 (16), as amended, as a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.

(ii) *Example.* A segregated asset account purchases a certificate of deposit in the amount of \$150,000 from bank A. Deposits in bank A are insured by the Federal Deposit Insurance Corporation, an instrumentality of the United States, to the extent of \$100,000 per depositor. The certificate of deposit is treated as a government security to the extent of the \$100,000 insured amount and is treated as a security issued by bank A to the extent of the \$50,000 excess of the value of the certificate of deposit over the insured amount.

(2) *Treasury security*—(i) *General rule.* For purposes of paragraph (b)(3) of this section and section 817(h)(3), the term *Treasury security* shall mean a security the direct obligor of which is the United States Treasury.

(ii) *Example.* A segregated asset account purchases put and call options on U.S. Treasury securities issued by the Options Clearing Corporation. The options are not Treasury securities for

purposes of paragraph (b)(3) and section 817(h)(3) because the direct obligor of the options is not the United States Treasury.

(3) *Real property.* The term *real property* shall mean any property that is treated as real property under 1.856-3 (d) except that it shall not include interests in real property.

(4) *Real property account.* A segregated asset account is a real property account on an anniversary of the account (within the meaning of paragraph (c)(2)(iii) of this section) or on the date a plan of liquidation is adopted if not less than the applicable percentage of the total assets of the account is represented by real property or interests in real property on such anniversary or date. For this purpose, the applicable percentage is 40% for the period ending on the first anniversary of the date on which premium income is first received, 50% for the year ending on the second anniversary, 60% for the year ending on the third anniversary, 70% for the year ending on the fourth anniversary, and 80% thereafter. A segregated asset account will also be treated as a real property account on its first anniversary if on or before such first anniversary the issuer has stated in the contract or prospectus or in a submission to a regulatory agency, an intention that the assets of the account will be primarily invested in real property or interests in real property, provided that at least 40% of the total assets of the account are so invested within six months after such first anniversary.

(5) *Commodity.* The term *commodity* shall mean any type of personal property other than a security.

(6) *Security.* The term *security* shall include a cash item and any partnership interest, whether or not registered under a Federal or State law regulating the offering or sale of securities. The term shall not include any interest in real property, or any interest in a commodity.

(7) *Interest in real property.* The term *interest in real property* shall include the ownership and co-ownership of land or improvements thereon and leaseholds of land or improvements thereon. Such term shall not, however, include mineral, oil, or gas royalty interests, such

as a retained economic interest in coal or iron ore with respect to which the special provisions of section 631(c) apply. The term "interest in real property" also shall include options to acquire land or improvements thereon, and options to acquire leaseholds of land or improvements thereon.

(8) *Interest in a commodity.* The term *interest in a commodity* shall include the ownership and co-ownership of any type of personal property other than a security, and any leaseholds thereof. Such term shall include mineral, oil, and gas royalty interests, including any fractional undivided interest therein. Such term also shall include any put, call, straddle, option, or privilege on any type of personal property other than a security.

(9) *Value.* The term *value* shall mean, with respect to investments for which market quotations are readily available, the market value of such investments; and with respect to other investments, fair value as determined in good faith by the managers of the segregated asset account.

(10) *Terms used in section 851.* To the extent not inconsistent with this paragraph (h) all terms used in this section shall have the same meaning as when used in section 851.

(i) *Effective date—(1) In general.* This section is effective for taxable years beginning after December 31, 1983.

(2) *Exceptions.* (i) If, at all times after December 31, 1983, an insurance company would be considered the owner of the assets of a segregated asset account under the principles of Rev. Rul. 81-225, 1981-2 C.B. 12, this section will not apply to such account until December 15, 1986.

(ii) This section will not apply to any variable contract to which Rev. Rul. 77-85, 1977-1 C.B. 12, or Rev. Rul. 81-225, 1981-2 C.B. 12, did not apply by reason of the limited retroactive effect of such rulings.

(iii) In determining whether a segregated asset account is adequately diversified for any calendar quarter ending before July 1, 1988, debt instruments that are issued, guaranteed, or insured by the United States or an instrumentality of the United States shall not be treated as government securities if such debt instruments are

secured by a mortgage on real property (other than real property owned by the United States or an instrumentality of the United States) or represent an interest in a pool of debt instruments secured by such mortgages.

(iv) This section shall not apply until January 1, 1989, with respect to a variable contract (as defined in section 817(d)) that (1) provides for the payment of an immediate annuity (as defined in section 72(u)(4)); (2) was outstanding on September 12, 1986; and (3) the segregated asset account on which it was based was, on September 12, 1986, wholly invested in deposits insured by the Federal Deposit Insurance Corporation or the Federal Savings and Loan Insurance Corporation.

(v) A segregated asset account in existence before March 1, 2005, will be considered to be adequately diversified if—

(A) As of March 1, 2005, the account was adequately diversified within the meaning of section 817(h) and this regulation as in effect prior to that date; and

(B) By December 31, 2005, the account is adequately diversified within the meaning of section 817(h) and this regulation.

[T.D. 8242, 54 FR 8730, Mar. 2, 1989; T.D. 8242, 54 FR 11866, Mar. 22, 1989; T.D. 9185, 70 FR 9872, Mar. 1, 2005; T.D. 9385, 73 FR 12265, Mar. 7, 2008]

§ 1.817A-0 Table of contents.

This section lists the captions that appear in section § 1.817A-1:

§ 1.817A-1 *Certain modified guaranteed contracts.*

- (a) Definitions.
 - (1) Modified guaranteed contract.
 - (2) Temporary guarantee period.
 - (3) Equity-indexed modified guaranteed contract.
 - (4) Non-equity-indexed modified guaranteed contract.
 - (5) Current market rate for non-equity-indexed modified guaranteed contract.
 - (6) Current market rate for equity-indexed modified guaranteed contract. [Reserved]
- (b) Applicable interest rates for non-equity-indexed modified guaranteed contracts.
 - (1) Tax reserves during temporary guarantee period.
 - (2) Required interest during temporary guarantee period.
 - (3) Application of section 811(d).