

Code Sec. 847(6)(A)

in an acquisition of assets referred to in section 381(a), if the company is not subject to the tax imposed by section 801 or section 831 for any taxable year, the entire amount in the account at the close of the preceding taxable year shall be subtracted from the account in such preceding taxable year and included in gross income.

(B) Elimination of balance of payments. In any case to which subparagraph (A) applies, any special estimated tax payment remaining after the credit attributable to the inclusion under subparagraph (A) shall be voided.

(7) Modification of the amount of special estimated tax payments in the event of subsequent marginal rate reduction or increase. In the event of a reduction in any tax rate provided under section 11 for any tax year after the enactment of this section, the Secretary shall prescribe regulations providing for a reduction in the amount of any special estimated tax payments made for years before the effective date of such section 11 rate reductions. Such reduction in the amount of such payments shall reduce the amount of such payments to the amount that they would have been if the special deduction permitted under paragraph (1) had occurred during a year that the lower marginal rate under section 11 applied. Similar rules shall be applied in the event of a marginal rate increase.

(8) Tax benefit determination. The tax benefit attributable to the deduction under paragraph (1) shall be determined under regulations prescribed by the Secretary, by taking into account tax benefits that would arise from the carryback of any net operating loss for the year, as well as current year tax benefits. Tax benefits for the current year and carryback years shall include those that would arise from the filing of a consolidated return with another insurance company required to determine discounted, unpaid losses under section 846 without regard to the limitations on consolidation contained in section 1503(c). The limitations on consolidation contained in section 1503(c) shall not apply to the deduction allowed under paragraph (1).

(9) Effect on earnings and profits. In determining the earnings and profits,—

(A) any special estimated tax payment made for any taxable year shall be treated as a payment of income tax imposed by this title for such taxable year, and

(B) any deduction or inclusion under this section shall not be taken into account.

Nothing in the preceding sentence shall be construed to affect the application of section 56(g) (relating to adjustments based on adjusted current earnings).

(10) Regulations. The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section, including regulations—

(A) providing for the separate application of this section with respect to each accident year,

(B) such adjustments in the application of this section as may be necessary to take into account the tax imposed by section 55, and

(C) providing for the application of this section in cases where the deduction allowed under paragraph (1) for any taxable year is less than the excess referred to in paragraph (1) for such year.

In 1989, P.L. 101-239, Sec. 7816(n)(1)(A), substituted "special estimated tax" for "separate estimated tax" in para. (1). Sec. 7816(n)(1)(B), substituted "in taxable years beginning after December 31, 1986" for "after December 31, 1986" in subpara. (1)(A). Sec. 7816(n)(2), amended the first sentence in para. (2). Sec. 7816(n)(3), added the last sentence to para. (5). Sec. 7816(n)(4), deleted "and" at the end of subpara. (9)(A), substituted "and" for the period at the end of subpara. (9)(B) and added subpara. (9)(C) [before redesignation by Sec. 7816(n)(5) of this Act, see below].

Insurance companies

Sec. 7816(n)(5), redesignated para. (9) as para. (10) and added new para. (9). Sec. 7816(n)(6), added the sentence at the end of para. (8), effective for tax yrs. begin after 12/31/87.

Prior to amendment, the first sentence in para. (2) read as follows: "The deduction under paragraph (1) shall be allowed only to the extent that special estimated tax payments are made in an amount equal to the tax benefit attributable to such deduction, on or before the date that any taxes (determined without regard to this section) for the taxable year for which the deduction is allowed are due to be paid."

In 1988, P.L. 100-647, Sec. 6077(a), added Code Sec. 847, effective for tax yrs. begin after 12/31/87.

Sec. 848. Capitalization of certain policy acquisition expenses.

(a) General rule.

In the case of an insurance company—

(1) specified policy acquisition expenses for any taxable year shall be capitalized, and

(2) such expenses shall be allowed as a deduction ratably over the 120-month period beginning with the first month in the second half of such taxable year.

(b) 5-Year amortization for first \$5,000,000 of specified policy acquisition expenses.

(1) In general. Paragraph (2) of subsection (a) shall be applied with respect to so much of the specified policy acquisition expenses of an insurance company for any taxable year as does not exceed \$5,000,000 by substituting "60-month" for "120-month".

(2) Phase-out. If the specified policy acquisition expenses of an insurance company exceed \$10,000,000 for any taxable year, the \$5,000,000 amount under paragraph (1) shall be reduced (but not below zero) by the amount of such excess.

(3) Special rule for members of controlled group. In the case of any controlled group—

(A) all insurance companies which are members of such group shall be treated as 1 company for purposes of this subsection, and

(B) the amount to which paragraph (1) applies shall be allocated among such companies in such manner as the Secretary may prescribe.

For purposes of the preceding sentence, the term "controlled group" means any controlled group of corporations as defined in section 1563(a); except that subsections (a)(4) and (b)(2)(D) of section 1563 shall not apply, and subsection (b)(2)(C) of section 1563 shall not apply to the extent it excludes a foreign corporation to which section 842 applies.

(4) Exception for acquisition expenses attributable to certain reinsurance contracts. Paragraph (1) shall not apply to any specified policy acquisition expenses for any taxable year which are attributable to premiums or other consideration under any reinsurance contract.

(c) Specified policy acquisition expenses.

For purposes of this section—

(1) In general. The term "specified policy acquisition expenses" means, with respect to any taxable year, so much of the general deductions for such taxable year as does not exceed the sum of—

(A) 1.75 percent of the net premiums for such taxable year on specified insurance contracts which are annuity contracts,

(B) 2.05 percent of the net premiums for such taxable year on specified insurance contracts which are group life insurance contracts, and

(C) 7.7 percent of the net premiums for such taxable year on specified insurance contracts not described in subparagraph (A) or (B).

Insurance companies

(2) General deductions. The term means the deductions provided in (Sec. 161 and following, relating to pension, profit sharing, etc.)

(d) Net premiums.

For purposes of this section—

(1) In general. The term "net premium" means the net premium for any category of specific contracts set forth in subsection (c)(1), the excess of—

(A) the gross amount of premiums on such contracts, over

(B) return premiums on such and other consideration incurred on such contracts.

The rules of section 803(b) shall apply to the preceding sentence.

(2) Amounts determined on an accrual basis. In computing net premiums for any taxable year, all computations shall be made on an accrual basis, and net premiums shall be determined in the manner required under section 803(b).

(3) Treatment of certain policy acquisition expenses. Net premiums for any taxable year shall be determined in the manner required under section 803(b) and shall be treated as paid to the policyholder.

(4) Special rules for reinsurance.

(A) Premiums and other consideration shall be taken into account only to the extent such consideration is includible in the taxable income of the insurance company taxable under this title.

(B) The Secretary shall prescribe such regulations as may be necessary to ensure that the net premium is determined consistently by the ceding and reinsuring companies.

(e) Classification of contracts. For purposes of this section—

(1) Specified insurance contracts.

(A) In general. Except as provided in this subsection, the term "specified insurance contract" means any life insurance, annuity, and health insurance contract (other than a reinsurance contract).

(B) Exceptions. The term "specified insurance contract" shall not include—

(i) any pension plan contract (other than a reinsurance contract),

(ii) any flight insurance contract,

(iii) any qualified foreign pension plan (other than a reinsurance contract), and

(iv) any contract which is described in section 220(d).

(2) Group life insurance contracts.

(A) which covers a group of persons for employment relationship, or similar fact,

(B) the premiums for which are paid on a basis, and

(9) as para. (10) and added new sentence at the end of paragraph 12/31/87.
 (10) as para. (2) read as follows: "(1) shall be allowed only to the extent payments are made in an amount not in excess of such deduction, on or before the due date of such deduction without regard to this section) deduction is allowed are due to

(a), added Code Sec. 847, effective 12/31/87.

Certain policy acquisition ex-

company—
 ion expenses for any taxable

allowed as a deduction ratably beginning with the first month of the taxable year.

first \$5,000,000 of specified

(2) of subsection (a) shall be such of the specified policy acquisition expenses for any taxable year exceeding \$5,000,000 by substituting

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(2) General deductions. The term "general deductions" means the deductions provided in part VI of subchapter B (Sec. 161 and following, relating to itemized deductions) and in part I of subchapter D (Sec. 401 and following, relating to pension, profit sharing, stock bonus plans, etc.).

(d) Net premiums.

For purposes of this section—

(1) In general. The term "net premiums" means, with respect to any category of specified insurance contracts set forth in subsection (c)(1), the excess (if any) of—

(A) the gross amount of premiums and other consideration on such contracts, over

(B) return premiums on such contracts and premiums and other consideration incurred for reinsurance of such contracts.

The rules of section 803(b) shall apply for purposes of the preceding sentence.

(2) Amounts determined on accrual basis. In the case of an insurance company subject to tax under part II of this subchapter, all computations entering into determinations of net premiums for any taxable year shall be made in the manner required under section 811(a) for life insurance companies.

(3) Treatment of certain policyholder dividends and similar amounts. Net premiums shall be determined without regard to section 808(e) and without regard to other similar amounts treated as paid to, and returned by, the policyholder.

(4) Special rules for reinsurance.

(A) Premiums and other consideration incurred for reinsurance shall be taken into account under paragraph (1)(B) only to the extent such premiums and other consideration are includible in the gross income of an insurance company taxable under this subchapter or are subject to tax under this chapter by reason of subpart F of part III of subchapter N.

(B) The Secretary shall prescribe such regulations as may be necessary to ensure that premiums and other consideration with respect to reinsurance are treated consistently by the ceding company and the reinsurer.

(e) Classification of contracts.

For purposes of this section—

(1) Specified insurance contract.

(A) In general. Except as otherwise provided in this paragraph, the term "specified insurance contract" means any life insurance, annuity, or noncancellable accident and health insurance contract (or any combination thereof).

(B) Exceptions. The term "specified insurance contract" shall not include—

(i) any pension plan contract (as defined in section 818(a)).

(ii) any flight insurance or similar contract,

(iii) any qualified foreign contract (as defined in section 807(c)(4) without regard to paragraph (5) of this subsection), and

(iv) any contract which is an Archer MSA (as defined in section 220(d)).

(2) Group life insurance contract. The term "group life insurance contract" means any life insurance contract—

(A) which covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor,

(B) the premiums for which are determined on a group basis, and

(C) the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

(3) Treatment of annuity contracts combined with noncancellable accident and health insurance. Any annuity contract combined with noncancellable accident and health insurance shall be treated as a noncancellable accident and health insurance contract and not as an annuity contract.

(4) Treatment of guaranteed renewable contracts. The rules of section 816(e) shall apply for purposes of this section.

(5) Treatment of reinsurance contract. A contract which reinsures another contract shall be treated in the same manner as the reinsured contract.

(f) Special rule where negative net premiums.

(1) In general. If for any taxable year there is a negative capitalization amount with respect to any category of specified insurance contracts set forth in subsection (c)(1)—

(A) the amount otherwise required to be capitalized under this section for such taxable year with respect to any other category of specified insurance contracts shall be reduced (but not below zero) by such negative capitalization amount, and

(B) such negative capitalization amount (to the extent not taken into account under subparagraph (A))—

(i) shall reduce (but not below zero) the unamortized balance (as of the beginning of such taxable year) of the amounts previously capitalized under subsection (a) (beginning with the amount capitalized for the most recent taxable year), and

(ii) to the extent taken into account as such a reduction, shall be allowed as a deduction for such taxable year.

(2) Negative capitalization amount. For purposes of paragraph (1), the term "negative capitalization amount" means, with respect to any category of specified insurance contracts, the percentage (applicable under subsection (c)(1) to such category) of the amount (if any) by which—

(A) the amount determined under subparagraph (B) of subsection (d)(1) with respect to such category, exceeds

(B) the amount determined under subparagraph (A) of subsection (d)(1) with respect to such category.

(g) Treatment of certain ceding commissions.

Nothing in any provision of law (other than this section or section 197) shall require the capitalization of any ceding commission incurred on or after September 30, 1990, under any contract which reinsures a specified insurance contract.

(h) Secretarial authority to adjust capitalization amounts.

(1) In general. Except as provided in paragraph (2), the Secretary may provide that a type of insurance contract will be treated as a separate category for purposes of this section (and prescribe a percentage applicable to such category) if the Secretary determines that the deferral of acquisition expenses for such type of contract which would otherwise result under this section is substantially greater than the deferral of acquisition expenses which would have resulted if actual acquisition expenses (including indirect expenses) and the actual useful life for such type of contract had been used.

(2) Adjustment to other contracts. If the Secretary exercises his authority with respect to any type of contract under paragraph (1), the Secretary shall adjust the percentage which would otherwise have applied under subsection (c)(1) to the category which includes such type of contract

Rules and Regulations

Federal Register

Vol. 59, No. 5

Friday, January 7, 1994

PART 1—INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1953

Accordingly, 26 CFR part 1 is corrected by making the following correcting amendment:

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In § 1.848-2(i)(4)(iii)(C), the language "Calculate the ratio between the results in paragraphs (i)(4)(ii) (A) and (B) of this section for each agreement;" is removed and the language "Calculate the ratio between the results in paragraphs (i)(4)(iii) (A) and (B) of this section for each agreement;" is added in its place.

Jacquelyn B. Burgess,

Alternate Federal Register Liaison Officer,
Assistant Chief Counsel (Corporate).

[FR Doc. 94-309 Filed 1-6-94; 8:45 am]

BILLING CODE 4830-01-U

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8456]

RIN 1545-AQ14

Capitalization of Certain Policy Acquisition Expenses; Correction

AGENCY: Internal Revenue Service,
Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains a correction to the final regulations (T.D. 8456), which were published Tuesday, December 29, 1992 (57 FR 61813), relating to the requirement that insurance companies capitalize specified policy acquisition expenses for tax purposes.

EFFECTIVE DATE: December 29, 1992.

FOR FURTHER INFORMATION CONTACT: Gary Geisler (202) 622-3970, (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of this correction contains final income tax regulations under section 848 of the Internal Revenue Code.

Need for Correction

As published, T.D. 8456 contains an error which may prove to be misleading and is in need of clarification.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Parts 1 and 602****[T.D. 8456]****RIN 1545-AQ14****Capitalization of Certain Policy
Acquisition Expenses***Correction*

In rule document 92-30943 beginning on page 61813 in the issue of Tuesday, December 29, 1992, make the following corrections:

1. On page 61817, in the first column, in the second and third lines, remove "The net negative foreign capitalization

amount."; and in the fourth line, remove "remaining portion of a".

§ 1.848-1 [Corrected]

2. On page 61820, in the second column, in § 1.848-1(h)(2)(vi), in the third line, "of" should read "or".

BILLING CODE 1550-01-0

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[T.D. 8456]

RIN 1545-AQ14

Capitalization on Certain Policy
Acquisition Expenses; CorrectionAGENCY: Internal Revenue Service,
Treasury.

ACTION: Correction to final regulations.

SUMMARY: This document contains a correction to Treasury Decision 8456, which was published in the Federal Register for Tuesday, December 29, 1992 (57 FR 61813). The final regulations relate to the requirement that insurance companies capitalize specified policy acquisition expenses for tax purposes.

EFFECTIVE DATE: December 29, 1992.

FOR FURTHER INFORMATION CONTACT:

Gary Geisler (202)-622-3970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of this correction provide rules under section 848 of the Internal Revenue Code.

Need for Correction

As published, T.D. 8456 contains an error which may prove to be misleading and is in need of clarification.

Correction of Publication

Accordingly, the publication of final regulations (T.D. 8456), which was the subject of FR Doc. 92-30943, is corrected as follows:

On page 61829, column 1, § 1.848-2(k)(2)(ii), fourth line, the language "without regard to the date on the" is corrected to read "without regard to the date on which the".

Cynthia Grigsby,

Alternate Federal Register Liaison Officer,
Assistant Chief Counsel (Corporate).

[FR Doc. 93-3183 Filed 2-10-93; 8:45 am]

BILLING CODE 4820-01-0

FOR FURTHER INFORMATION CONTACT: Gary Geisler, 202-622-3970 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information requirement contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1287. The estimated annual burden per respondent varies from 15 minutes to 20 hours, depending on individual circumstances, with an estimated average of 1 hour.

These estimates are an approximation of the average time expected to be necessary to collect information. They are based on such information as is available to the Internal Revenue Service. Individual respondents may require greater or less time, depending on their particular circumstances.

Comments concerning the accuracy of these burdens estimates and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attention: IRS Reports Clearance Officer, TFP, Washington, DC 20224; and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document contains final income tax regulations under section 848 of the Internal Revenue Code (Code), relating to the capitalization of certain policy acquisition expenses of insurance companies. Section 848 was added to the Code by section 11301(a) of the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508. Proposed regulations under section 848 were published in the Federal Register on November 15, 1991 (56 FR 58003). Written comments were received from the public and a public hearing was held on January 31, 1992. After consideration of all written and oral comments regarding the proposed regulations, those regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

Section 848 provides that insurance companies must capitalize "specified policy acquisition expenses." In lieu of identifying the categories of expenses that must be capitalized, section 848 requires that a company capitalize an amount of otherwise deductible expenses equal to specified percentages

of net premiums with respect to certain types of insurance contracts. These capitalized amounts are called "specified policy acquisition expenses." The maximum amount of specified policy acquisition expenses required to be capitalized in any taxable year is generally limited to the insurance company's "general deductions" for that year.

Categories of Specified Insurance Contracts

Under sections 848 (c) and (e), the amounts treated as specified policy acquisition expenses depend on whether a particular contract is classified as an annuity contract, a group life insurance contract, or "other specified insurance contract."

The proposed regulations contain definitions of the types of contracts to which the provisions of section 848 apply. They also define a "combination contract" (that is, a contract providing more than one type of insurance or annuity coverage) and provide rules for applying the capitalization requirement to premiums under a combination contract.

Combination Contracts

In response to comments, the final regulations modify the treatment of premiums under a combination contract. The final regulations define a combination contract as a contract that provides two or more types of coverage, one of which if provided separately would be a life insurance contract, an annuity, or a noncancellable or guaranteed renewable accident and health insurance contract. The regulations generally provide that if the premiums relating to each type of insurance coverage provided by a combination contract are separately stated on the insurance company's annual statement, the separately stated premiums are treated in the same manner as premiums under separate contracts. If premiums allocable to any type of coverage provided under a combination contract are not separately stated, the premium for the entire contract is subject to the highest capitalization percentage applicable to any of the coverages provided by the contract.

Special rules apply in the case of de minimis premiums. De minimis premiums are not required to be separately stated. If the separate statement rule is otherwise satisfied but for de minimis premiums, the de minimis premiums are required to be treated consistently with the characterization of these premiums on the insurance company's annual

6 CFR Parts 1 and 602

(D. 8458)

IN 1545-AQ14

Capitalization of Certain Policy Acquisition Expenses

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the requirement that insurance companies capitalize specified policy acquisition expenses for tax purposes. Changes to the applicable law were made by the Revenue Reconciliation Act of 1990. The regulations are necessary to provide guidance to insurance companies that must comply with the capitalization requirement.

EFFECTIVE DATE: September 30, 1990.

statement. Furthermore, in determining the highest capitalization percentage applicable to any of the coverages provided by the contract, the coverage to which a de minimis premium is allocable is disregarded. For purposes of these provisions, premiums allocable to a type of coverage considered de minimis if the premiums are 2 percent or less of the entire premium for the contract.

Definition of Group Life Insurance

Under section 848(c), a lower capitalization percentage is applied to premiums received on a group life insurance contract than to premiums received with respect to an individual life insurance contract. Section 848(e)(2) defines a group life insurance contract as one which satisfies three requirements. The first requirement is an affiliation requirement; that is, the contract must cover "a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor."

The proposed regulations specify five categories of eligible groups as satisfying the affiliation requirement: an employee group, a debtor group, a labor union group, a credit union group, and an association group satisfying certain conditions. The proposed regulations also allow multiple groups consisting of combinations of groups from the same category.

The categories of eligible groups in the proposed regulations include the specific group categories referred to in the Group Life Insurance Definition and Group Life Insurance Standard Provisions Model Act approved by the National Association of Insurance Commissioners. Unlike the Model Act, the proposed regulations make no provision for a discretionary group that satisfies the requirements of the applicable state law to be treated as an eligible group. The preamble to the proposed regulations requested public comment concerning the desirability of expanding the group life insurance definition to include discretionary groups.

In response to comments, the final regulations list a number of discretionary groups that will also be treated as satisfying the affiliation requirement of section 848(e)(2)(A). The final regulations also authorize the Commissioner to specify other discretionary groups as satisfying the group affiliation requirement in subsequent guidance published in the Internal Revenue Bulletin.

Comments stated that a contract covering members from different categories of eligible groups should be

treated as a group contract. In general, these comments were not adopted because the Model Act does not specifically authorize these contracts. The final regulations, however, allow employees to be included as members of a group sponsored by an association, a labor union, or a credit union. The regulations also allow members of a credit union to be covered under a single contract whether in their capacity as members or as borrowers of the credit union.

Comments were received asking that the prohibition of determining a group (or class within a group) on the basis of individual health characteristics be clarified such that a pre-retirement age requirement or active work requirement would be allowed. Comments also requested clarification of the application of the identical premium requirement in the context of the separate employer units covered by a single contract issued to a multi-employer trust. The final regulations adopt these comments.

The second requirement for qualification as a group life insurance contract is that the premiums for a group life insurance contract must be determined on a group basis. The proposed regulations set forth a two-part test to determine whether premiums for a contract are determined on a group basis: an identical premium requirement and an eligibility requirement.

Under the identical premium requirement, the only permissible differences in premiums charged with respect to any member of the group are those reflecting the member's actual age (in years), the member's gender, or the member's smoking habits. Under the eligibility requirement, all members of the group generally must be eligible for the coverage provided under the contract without regard to evidence of insurability.

The proposed regulations provide two exceptions with respect to the eligibility requirement. First, in the case of group term life insurance coverage, the proposed regulations allow the insurance company to deny or limit coverage based on a member's response to a medical questionnaire (but not on any other basis, such as a medical examination). Secondly, a denial or limitation of coverage to any member is allowed on the basis of medical information obtained with respect to that member prior to January 1, 1993.

Public comments generally endorsed the use of an identical premium requirement as a means for determining whether premiums for the contract are determined on a group basis. The comments suggested a number of changes to the identical premium

requirement to clarify the application of this test. The final regulations adopt most of these comments. For example, the regulations provide that the identical premium requirement is satisfied if the premium rates charged by the insurance company for the corresponding units of coverage (for example, per \$1,000 of face amount of insurance) provided to each member of the group are the same, except for differences attributable to the age, gender, or smoking habits of the member.

A large number of comments objected to the proposed regulations' requirement that all members of the group generally must be eligible for coverage without regard to evidence of insurability. It was stressed that under state law, an insurance company may deny or limit coverage to any member of the group in the absence of satisfactory evidence of individual insurability, and that the accepted group underwriting practice is to require evidence of individual insurability beyond a medical questionnaire in cases when there is a high likelihood of anti-selection against the insurer. The comments stated that other rules in the proposed regulations, such as the group affiliation requirement and the identical premium requirement, clearly differentiate the coverage under a group life insurance contract from that of individual life insurance.

In response to these comments, the final regulations do not contain the eligibility requirement. Future regulations may address company underwriting practices for group life insurance contracts if, for example, changes in business practice or a shift in premiums from the individual to the group category indicate the need for further guidance. If additional guidance addressing the eligibility requirement is contemplated, the guidance would be first published in a notice of proposed rulemaking and, if adopted, would be applied prospectively.

A third requirement for qualification as a group life insurance contract is that the proceeds of the contract are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person. In response to comments, the final regulations clarify the usage of the term "organization" in this context to include only the organization that is either the sponsor of the contract or the group policyholder. It is intended that other life insurance in which the proceeds are used similarly to credit life insurance (for example, pre-need burial insurance) will not be treated as violating the

restriction on the payment of proceeds to the sponsoring organization or group policyholder.

The final regulations also adopt new rules to address the situation in which the requirements of the regulations are not satisfied with respect to a small number of individuals covered by a group contract. Under the proposed regulations, if the group life insurance requirements are not met with respect to all members of the group, the premiums for the entire contract are treated as received under an individual life insurance contract. Comments indicated that an ineligible individual or individuals may temporarily obtain coverage under a group contract (through inadvertence of the group policyholder or otherwise), and that one individual or a small number of individuals should not disqualify the entire premium for the contract. In response to these comments, the final regulations provide that if the premiums allocable to an ineligible member (or members) are no more than 5 percent of the total premiums charged by the insurance company for the group as a whole, then only the premiums allocable to ineligible member (or members) will be treated as individual life insurance premiums.

General Deductions

The final regulations clarify that the determination of general deductions under section 848(c)(2) is made without regard to any amount capitalized under section 848(a) in any taxable year. This clarification eliminates any circularity with respect to the determination of general deductions under section 848(c)(2) and the capitalization of specified policy acquisition expenses or the taxable year.

Definition of Net Premiums

Section 848(d)(1) provides that, with respect to each category of specified insurance contracts, net premiums equal the excess, if any, of the gross amount of premiums and other consideration for the contracts, over the sum of return premiums and premiums incurred for the reinsurance of the contracts. Pursuant to section 848(d)(3), the gross amount of premiums and other consideration does not include certain policyholder dividends and similar amounts that, under section 808(e), are treated as paid to the policyholder and returned to the insurance company as a premium.

Policy Exchanges

The proposed regulations provide that an insurance or annuity contract is exchanged (within the meaning of

section 1001) for a specified insurance contract, the insurance company must include the fair market value of the contract issued in the exchange in its gross amount of premiums and other consideration for the issuance of a new specified insurance contract. The preamble to the proposed regulations requested comments whether this treatment of exchanges of insurance contracts (initiated by either a policyholder or the company) would require an insurance company to capitalize excessive amounts.

Many comments questioned whether under the proposed regulations many routine policy changes, such as the addition or deletion of a rider, might result in the capitalization of existing contract values. The comments generally urged that only external exchanges (that is, exchanges involving a different insurance company) should give rise to net premiums under section 848.

In response to comments, the treatment of exchanges of insurance or annuity contracts is modified in the final regulations. Except as otherwise provided by the regulations, an exchange (including a change in the terms of a specified insurance contract) will not give rise to net premiums under section 848. The regulations identify specific types of exchanges that will cause net premiums to be subject to section 848. These situations are (1) external exchanges (that is, exchanges involving a different insurance company), and (2) internal exchanges which result in the issuance of fundamentally different contracts.

Under the final regulations, an internal exchange is considered to result in the issuance of a fundamentally different contract if the contract issued in the exchange (1) belongs to a different category of specified insurance contract (or is issued in exchange for a nonspecified insurance contract), (2) changes the identity of the individual insured, or (3) changes the mortality, morbidity, interest, or expense guarantees with respect to nonforfeiture benefits provided in the exchanged contract.

The final regulations identify certain modifications that will not be treated as changing the mortality, morbidity, interest, or expense guarantees and authorize the Commissioner to identify other modifications in subsequent guidance published in the Internal Revenue Bulletin. The regulations also provide an exception for contracts that are restructured pursuant to a rehabilitation, conservatorship, insolvency, or similar state proceeding.

A finding of insolvency is not necessary to qualify for this exception.

The final regulations also clarify the amount that is taken into account as the value of the new contract issued in an exchange that generates net premiums under section 848. The value of the new contract is generally determined by the most recent sale by the insurance company of a comparable contract, or if this value is not readily ascertainable, by reference to the interpolated terminal reserve of the original contract. The final regulations permit a lesser value to be used for an exchange of contracts made pursuant to a policy enhancement or update transaction. The regulations also provide that in the case of any exchange involving a group term life insurance contract without cash value, the value of the new contract is deemed to be zero.

Dividend Accumulations

The proposed regulations provide that an amount deposited with an insurance company is not treated as a premium until it is applied to, or irrevocably committed to, the payment of premiums on a specified insurance contract. Amounts left on deposit with an insurance company in a dividend accumulation account are not treated as irrevocably committed to the payment of premiums.

Numerous comments asked that dividend accumulations used to pay premiums on a specified insurance contract be treated like "other similar amounts" under section 848(d)(3). This comment was not adopted because amounts credited to a dividend accumulation account are treated as taxable deposits held on behalf of the policyholder and are not committed to the payment of premiums on a specified insurance contract.

Reinsurance

The capitalization requirements of section 848 apply to premiums and other consideration for reinsurance agreements. Under section 848(d)(1), the ceding company reduces its gross amount of premiums and other consideration by the amount that it incurs as premiums for reinsurance. Correspondingly, the reinsurer includes the reinsurance premiums in its gross amount of premiums and other consideration.

Section 848(d)(4)(B) authorizes the Treasury Department to prescribe regulations to ensure that "premiums and other consideration with respect to reinsurance" are treated consistently by the parties of a reinsurance agreement in applying the provisions of section 848.

Pursuant to this regulatory authority, the proposed regulations set forth rules identifying the amounts that are to be taken into account in determining the parties' premiums and other consideration for reinsurance under section 848(d)(1). Under the proposed regulations, all items of consideration transferred between a ceding company and a reinsurer pursuant to a reinsurance agreement are netted. The net negative consideration determined by one party to a reinsurance agreement reduces its net premiums under section 848(d)(1)(B). The net positive consideration determined by the other party increases its net premiums under section 848(d)(1)(A). The determination of net consideration for the reinsurance agreement ensures consistency between the parties. This consistency extends to the amount and timing, as well as the character, of items. The net consideration rules of the proposed regulations apply to all amounts incurred under a reinsurance agreement for taxable years beginning after December 31, 1991.

The proposed regulations also address a second problem that may arise in reinsurance transactions. The capitalization requirements of section 848 could be avoided if, for example, a primary insurer reinsures its business with a reinsurer whose general deductions are disproportionately small. To prevent this avoidance, the proposed regulations limit a party's use of the net negative consideration on a reinsurance agreement to reduce its net premiums if the other party did not capitalize the net positive consideration due to that party's general deductions limitation. Under the proposed regulations, this potential reduction applies to all amounts arising under any reinsurance agreement executed on or after November 15, 1991, and to all amounts arising under any reinsurance agreement for taxable years beginning after December 31, 1991, without regard to when the reinsurance agreement was entered into.

Net Consideration Rules

Several comments addressed the determination of net consideration for reinsurance agreements. One set of comments urged that claims and benefit reimbursements be excluded from the determination of net consideration for reinsurance. Other comments urged the retention of all items of consideration (including claims and benefit reimbursements) in determining net consideration for reinsurance. Finally, a third set of comments urged the adoption of separate rules for determining premiums and other

consideration for reinsurance depending on the type of reinsurance agreement involved.

The final regulations generally retain the rules relating to the determination of net consideration for reinsurance agreements that were entered into after November 14, 1991, for taxable years beginning after December 31, 1991. In response to comments, the regulations postpone the effective date of the net consideration rules for other reinsurance agreements. The regulations provide that for reinsurance agreements entered into prior to November 15, 1991, the net consideration rules apply only to amounts arising for taxable years beginning after December 31, 1994. For taxable years beginning before January 1, 1995, the parties must account for premiums and other consideration for the agreement using the interim rules of the proposed regulations.

The final regulations also contain a special rule that applies to a funds-withheld reinsurance agreement that was entered into after November 14, 1991, but before the first day of the first taxable year beginning after December 31, 1991, and was terminated before January 1, 1995. Under this rule, the parties' net consideration for the year of termination must include the amount of the original reserve for any reinsured specified insurance contract that, in applying the provisions of subchapter L, is treated as premiums and other consideration for reinsurance in the taxable year for which the agreement becomes effective.

Reduction in the Amount of Net Negative Consideration To Ensure Consistency of Capitalization for Reinsurance Agreements

The comments generally supported the rule in the proposed regulations that provided for a reduction in the amount of net negative consideration that a party to reinsurance agreement could take into account to reduce its net premiums if the other party did not capitalize the net positive consideration because of the other party's general deductions limitation. Some comments requested that the regulations specify the manner of demonstrating consistency of capitalization between the parties of a reinsurance agreement (such as an affidavit from the party with net positive consideration). Although the regulations do not adopt this comment, the Internal Revenue Service is considering whether to provide an administrative means of demonstrating consistency of capitalization in subsequent guidance published in the Internal Revenue Bulletin.

Reinsurance Agreements With Parties Not Subject to United States Taxation

Section 848(d)(4)(A) provides that premiums and other consideration incurred for reinsurance may be taken into account as a reduction of net premiums only to the extent that the premiums are includible in the gross income of an insurance company which is taxable under subchapter L, or whose shareholders are subject to United States taxation on the reinsurance premiums by reason of subpart F of part III of subchapter N. The proposed regulations provide that a party to a reinsurance agreement may not reduce its net premiums by the net negative consideration on a reinsurance agreement if the other party is neither an insurance company subject to tax under subchapter L nor a controlled foreign corporation. The proposed regulations do not address the treatment of net positive consideration on reinsurance agreements with parties not subject to United States taxation.

Several comments urged that the regulations exclude from net premiums any net positive consideration from reinsurance agreements with parties that are not subject to United States taxation. The comments expressed concern that unless these net positive consideration amounts are eliminated, the rules in the proposed regulations could result in a double counting of a party's net premiums.

In response to the comments, the final regulations provide an election to separately determine the amounts required to be capitalized for reinsurance agreements with parties not subject to United States taxation with respect to the premiums and other consideration under the agreements. If the election is made, a capitalization amount (either positive or negative) is determined for each category of specified insurance contracts based on the net premiums for each category. The capitalization amounts for all the categories of contracts are then aggregated to arrive at a "net foreign reinsurance capitalization amount" (either positive or negative) for the taxable year on all reinsurance agreements with parties that are not subject to United States taxation.

If the net foreign capitalization amount for any taxable year is negative, the negative amount is applied to reduce (but not below zero) the unamortized balances of amounts previously capitalized (beginning with the most recent taxable year) to the extent attributable to prior years' net positive foreign capitalization amounts. The reduction of the previously

capitalized amounts is allowed as a deduction for the taxable year. The net negative foreign capitalization amount. The remaining portion of a net negative foreign capitalization amount, if any, remaining after this reduction is carried over and used to offset a future year's net positive foreign capitalization amount. The remaining portion of a net negative foreign capitalization amount may not reduce the amounts otherwise required to be capitalized for the taxable year with respect to directly written business or reinsurance agreements with parties that are subject to United States taxation.

A net positive foreign capitalization amount (after reduction by any carryover amount from preceding years) is added to the specified policy acquisition expenses required to be capitalized for the taxable year (determined without regard to amounts taken into account under the election). Thus, a net positive foreign capitalization amount is capitalized independently of the general deductions limitation.

The rules in the final regulations with respect to the determination of net foreign capitalization amounts generally apply to taxable years beginning after November 14, 1991. Under the regulations, however, an insurance company may make an election to apply the rules with respect to the determination of net foreign capitalization amounts for earlier taxable years by filing an amended federal income tax return.

Carryover of Excess Negative Capitalization Amount

Section 848(f)(1) authorizes an insurance company to reduce the amount of the current year's capitalization of specified policy acquisition expenses and the unamortized balances of specified policy acquisition expenses for preceding years if there is a "negative capitalization amount" for a category of specified insurance contracts. The negative capitalization amount is determined by multiplying the negative net premiums for a category of specified insurance contracts by the applicable percentage set forth in section 848(c)(1) from that category of specified contracts. As a practical matter, a negative capitalization amount for a category of specified insurance contracts will generally only arise as a result of reinsurance agreements.

In response to comments, the final regulations add rules that permit an insurance company to carry over to future years the portion of any negative capitalization amount remaining after

the reductions specified in section 848(f)(1). This provision of the regulations is effective for taxable years ending on or after September 30, 1990.

Reinsurance Agreements Involving Insolvent Insurance Companies

The proposed regulations authorize the Commissioner to grant a waiver excluding from the capitalization requirement any reinsurance consideration relating to agreements approved by a state court supervising the rehabilitation or liquidation of an insolvent company. The proposed regulations do not specify the conditions that would allow an insurance company undergoing a rehabilitation, conservatorship, liquidation, or similar state proceeding to be treated as "insolvent."

In response to comments, the final regulations adopt specific rules for the treatment of reinsurance agreements involving insolvent insurance companies. The rules operate in conjunction with the provisions allowing the carryover of an excess negative capitalization amount under section 848(f). Under the final regulations, an insolvent insurance company with an excess negative capitalization amount as a result of a reinsurance agreement and the party with net positive consideration under that agreement may make a joint election. The joint election requires the insolvent company to forego the carryover of the portion of the excess negative capitalization amount attributable to the agreement and allows the party with net positive consideration to reduce its specified policy acquisition expenses for the taxable year by an amount equal to the portion of the insolvent company's excess negative capitalization amount that is not carried over. The final regulations also specify certain conditions occurring as part of a state supervised proceeding that will cause the insurance company that is the subject of this proceeding to be presumed to be insolvent.

The provisions of the final regulations relating to reinsurance agreements involving insolvent companies are effective for taxable years ending on or after September 30, 1990. The joint election of an insolvent insurance company and a reinsurer may be made on an amended return.

Application of the Capitalization Requirements in the Context of Corporate Adjustment

The preamble to the proposed regulations requested comments concerning the applicability of section

848 to reinsurance agreements undertaken in the context of corporate adjustments, such as different non-recognition transactions under subchapter C. Several comments were received on this issue. The comments requested that the regulations also provide guidance regarding the application of section 848 to stock acquisitions that are treated as asset acquisitions under section 338.

Due to the complexity of this area of the tax law, these regulations do not adopt rules relating to the application of section 848 to reinsurance agreements affected as part of non-recognition transactions and other corporate adjustments. The application of section 848 in the context of different subchapter C transactions will be the subject of forthcoming proposed regulations. The Treasury Department and the Internal Revenue Service continue to invite comments on the application of section 848 to these transactions.

Coordination With Subchapter N

The final regulations do not address the treatment of amounts required to be capitalized under section 848 for purposes of subchapter N (including rules concerning source of income, allocation and apportionment of expenses, and computation of the foreign tax credit). The Treasury Department and the Internal Revenue Service request comments on any issues relating to the coordination of section 848 and subchapter N that should be addressed in these forthcoming proposed regulations.

Special Analyses

It has been determined that these regulations are not major rules as defined in Executive Order 12291. Therefore, a Regulatory Impact Analysis is not required. It has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a final Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking for these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Gary Geisler of the Office of the Assistant Chief Counsel (Financial Institutions and Products), Internal Revenue Service. However,

personnel from other offices of the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR 1.801-1 Through 1.860-5

Income taxes, Insurance companies, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

For the reasons set forth in the preamble, 26 CFR parts 1 and 602 are amended as follows:

PART 1—[AMENDED]

Paragraph 1. The authority citation for part 1 is amended by adding the following citations:

Authority: 26 U.S.C. 7805 * * * Section 1.848-2 also issued under 26 U.S.C. 845(b) and 26 U.S.C. 848(d)(4)(B). Section 1.848-3 also issued under 26 U.S.C. 848(d)(4)(B).

Par. 2. Sections 1.848-0, 1.848-1, 1.848-2, and 1.848-3 are added to read as follows:

§ 1.848-0 Outline of regulations under section 848.

This section lists the paragraphs in §§ 1.848-1 through 1.848-3.

§ 1.848-1 Definitions and special provisions.

- (a) Scope and effective date.
- (b) Specified insurance contract.
 - (i) In general.
 - (2) Exceptions.
 - (i) In general.
 - (ii) Reinsurance of qualified foreign contracts.
- (c) Life insurance contract.
- (d) Annuity contract.
- (e) Noncancellable accident and health insurance contract.
- (f) Guaranteed renewable accident and health insurance contract.
- (g) Combination contract.
 - (1) Definition.
 - (2) Treatment of premiums on a combination contract.
 - (i) In general.
 - (ii) De minimis premiums.
 - (3) Example.
- (h) Group life insurance contract.
 - (1) In general.
 - (2) Group affiliation requirement.
 - (i) In general.
 - (ii) Employee group.
 - (iii) Debtor group.
 - (iv) Labor union group.
 - (v) Association group.
 - (vi) Credit union group.
 - (vii) Multiple group.
 - (viii) Certain discretionary groups.
 - (ix) Employees treated as members.

- (x) Class or classes of a group determined without regard to individual health characteristics.
- (A) In general.
- (B) Limitation of coverage based on certain work and age requirements permissible.
- (3) Premiums determined on a group basis.
 - (i) In general.
 - (ii) Exception for substandard premium rates for certain high risk insureds.
 - (iii) Flexible premium contracts.
 - (iv) Determination of actual age.
 - (4) Underwriting practices used by company. [Reserved]
 - (5) Disqualification of group.
 - (i) In general.
 - (ii) Exception for de minimis failures.
 - (6) Supplemental life insurance coverage.
 - (7) Special rules relating to the payment of proceeds.
 - (i) Contracts issued to a welfare benefit fund.
 - (ii) Credit life insurance contracts.
 - (iii) "Organization or association" limited to the sponsor of the contract or the group policyholder.
 - (i) General deductions.

§ 1.848-2 Determination of net premiums.

- (a) Net premiums.
 - (1) In general.
 - (2) Separate determination of net premiums for certain reinsurance agreements.
- (b) Gross amount of premiums and other consideration.
 - (1) General rule.
 - (2) Items included.
 - (3) Treatment of premium deposits.
 - (i) In general.
 - (ii) Amounts irrevocably committed to the payment of premiums.
 - (iii) Retired lives reserves.
 - (4) Deferred and uncollected premiums.
- (c) Policy exchanges.
 - (1) General rule.
 - (2) External exchanges.
 - (3) Internal exchanges resulting in fundamentally different contracts.
 - (i) In general.
 - (ii) Certain modifications treated as not changing the mortality, morbidity, interest, or expense guarantees.
 - (iii) Exception for contracts restructured by a court supervised rehabilitation or similar proceeding.
 - (4) Value of the contract.
 - (i) In general.
 - (ii) Special rule for group term life insurance contracts.
 - (iii) Special rule for certain policy enhancement and update programs.
 - (A) In general.
 - (B) Policy enhancement or update program defined.
 - (5) Example.
 - (d) Amounts excluded from the gross amount of premiums and other consideration.
 - (1) In general.
 - (2) Amounts received or accrued from a guaranty association.
 - (3) Exclusion not to apply to dividend accumulations.
 - (e) Return premiums.
 - (f) Net consideration for a reinsurance agreement.
 - (1) In general.
 - (2) Net consideration determined by a ceding company.
 - (i) In general.
 - (ii) Net negative and net positive consideration.
 - (3) Net consideration determined by the reinsurer.
 - (i) In general.
 - (ii) Net negative and net positive consideration.
 - (4) Timing consistency required.
 - (5) Modified coinsurance and funds-withheld reinsurance agreements.
 - (i) In general.
 - (ii) Special rule for certain funds-withheld reinsurance agreements.
 - (6) Treatment of retrocessions.
 - (7) Mixed reinsurance agreements.
 - (8) Treatment of policyholder loans.
 - (9) Examples.
 - (g) Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements.
 - (1) In general.
 - (2) Application to reinsurance agreements subject to the interim rules.
 - (3) Amount of reduction.
 - (4) Capitalization shortfall.
 - (5) Required capitalization amount.
 - (i) In general.
 - (ii) Special rule with respect to net negative consideration.
 - (6) General deductions allocable to reinsurance agreements.
 - (7) Allocation of capitalization shortfall among reinsurance agreements.
 - (8) Election to determine specified policy acquisition expenses for an agreement without regard to general deductions limitation.
 - (i) In general.
 - (ii) Manner of making election.
 - (iii) Election statement.
 - (iv) Effect of election.
 - (9) Examples.
 - (h) Treatment of reinsurance agreements with parties not subject to U.S. taxation.
 - (1) In general.
 - (2) Agreements to which this paragraph (h) applies.
 - (i) In general.
 - (ii) Parties subject to U.S. taxation.
 - (A) In general.
 - (B) Effect of a closing agreement.
 - (3) Election to separately determine the amounts required to be capitalized for reinsurance agreements with parties not subject to U.S. taxation.
 - (i) In general.
 - (ii) Manner of making the election.
 - (4) Amount taken into account for purposes of determining specified policy acquisition expenses.
 - (5) Net foreign capitalization amount.
 - (i) In general.
 - (ii) Foreign capitalization amounts by category.
 - (6) Treatment of net negative foreign capitalization amount.

- (i) Applies as a reduction to previously capitalized amounts.
- (ii) Carryover of remaining net negative foreign capitalization amount.
- (7) Reduction of net positive foreign capitalization amount by carryover amounts allowed.
- (8) Examples.
- (i) Carryover of excess negative capitalization amount.
 - (1) In general.
 - (2) Excess negative capitalization amount.
 - (3) Treatment of excess negative capitalization amount.
 - (4) Special rule for the treatment of an excess negative capitalization amount of an insolvent company.
 - (i) When applicable.
 - (ii) Election to forego carryover of excess negative capitalization amount.
 - (iii) Amount of reduction to the excess negative capitalization amount and specified policy acquisition expenses.
 - (iv) Manner of making election.
 - (v) Presumptions relating to the insolvency of an insurance company undergoing a court supervised rehabilitation or similar state proceeding.
 - (vi) Example.
- (j) Ceding commissions with respect to reinsurance of contracts other than specified insurance contracts.
- (k) Effective dates.
 - (1) In general.
 - (2) Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements.
 - (3) Net consideration rules.
 - (4) Determination of the date on which a reinsurance agreement is entered into.
 - (5) Special rule for certain reinsurance agreements with parties not subject to U.S. taxation.
 - (6) Carryover of excess negative capitalization amount.

§ 1.848-3 Interim rules for certain reinsurance agreements.

- (a) Scope and effective dates.
- (b) Interim rules.
- (c) Adjustments and special rules.
 - (1) Assumption reinsurance.
 - (2) Reimbursable dividends.
 - (3) Ceding commissions.
 - (i) In general.
 - (ii) Amount of ceding commission.
 - (4) Termination payment.
 - (5) Modified coinsurance agreements.
- (d) Examples.

§ 1.848-1 Definitions and special provisions.

(a) *Scope and effective date.* The definitions and special provisions in this section apply solely for purposes of determining specified policy acquisition expenses under section 848 of the Internal Revenue Code, this section, and §§ 1.848-2 and 1.848-3. Unless otherwise specified, the rules of this section are effective for the taxable years of an insurance company beginning after November 14, 1991.

(b) *Specified insurance contract—(1) In general.* A "specified insurance contract" is any life insurance contract, annuity contract, noncancellable or guaranteed renewable accident and health insurance contract, or combination contract. A reinsurance agreement that reinsures the risks under a specified insurance contract is treated in the same manner as the reinsured contract.

(2) *Exceptions—(i) In general.* A "specified insurance contract" does not include any pension plan contract (as defined in section 818(a)), flight insurance or similar contract, or qualified foreign contract (as defined in section 807(e)(4)).

(ii) *Reinsurance of qualified foreign contracts.* The exception for qualified foreign contracts does not apply to reinsurance agreements that reinsure qualified foreign contracts.

(c) *Life insurance contract.* A "life insurance contract" is any contract—
(1) Issued after December 31, 1984, that qualifies as a life insurance contract under section 7702(a) (including an endowment contract as defined in 7702(h)); or

(2) Issued prior to January 1, 1985, if the premiums on the contract are reported as life insurance premiums on the insurance company's annual statement (or could be reported as life insurance premiums if the company were required to file the annual statement for life and accident and health companies).

(d) *Annuity contract.* An "annuity contract" is any contract (other than a life insurance contract as defined in paragraph (c) of this section) if amounts received under the contract are subject to the rules in section 72(b) or section 72(e) (determined without regard to section 72(u)). The term "annuity contract" also includes a contract that is a qualified funding asset under section 130(d).

(e) *Noncancellable accident and health insurance contract.* The term "noncancellable accident and health insurance contract" has the same meaning for purposes of section 848 as the term has for purposes of section 816(b).

(f) *Guaranteed renewable accident and health insurance contract.* The term "guaranteed renewable accident and health insurance contract" has the same meaning for purposes of section 848 as the term has for purposes of section 816(e).

(g) *Combination contract—(1) Definition.* A "combination contract" is a contract (other than a contract described in section 848(e)(3)) that provides two or more types of insurance

coverage, at least one of which if offered separately would be a life insurance contract, an annuity contract, or a noncancellable or guaranteed renewable accident and health insurance contract.

(2) *Treatment of premiums on a combination contract—(i) In general.* If the premium allocable to each type of insurance coverage is separately stated on the insurance company's annual statement (or could be separately stated if the insurance company were required to file the annual statement for life and accident and health companies), the premium allocable to each type of insurance coverage in a combination contract is subject to the capitalization rate, if any, that would apply if that coverage was provided in a separate contract. If the premium allocable to each type of insurance coverage in a combination contract is not separately stated, the entire premium is subject to the highest capitalization percentage applicable to any of the coverages provided.

(ii) *De minimis premiums.* For purposes of this paragraph (g)(2)—

(A) A de minimis premium is not required to be separately stated;

(B) In determining the highest capitalization percentage applicable to a combination contract, the coverage to which a de minimis premium is allocable is disregarded;

(C) If the separate statement requirement of this paragraph (g)(2) is satisfied, a de minimis premium is treated in accordance with its characterization on the insurance company's annual statement; and

(D) Whether a premium for an insurance coverage is de minimis is determined by comparing that premium with the aggregate of the premiums for the combination contract. A premium that is not more than 2 percent of the premium for the entire contract is considered de minimis. Whether a premium that is more than 2 percent is de minimis is determined based on all the facts and circumstances.

(3) *Example.* The principles of this paragraph (g) are illustrated by the following example.

Example. A life insurance company (L1) issues a contract to an employer (X), which provides cancellable accident and health insurance coverage and group term life insurance coverage to X's employees. L1 charges a premium of \$1,000 for the contract, \$950 of which is attributable to the cancellable accident and health insurance coverage and \$50 of which is attributable to the group term life insurance coverage. On its annual statement, L1 reports the premiums attributable to the accident and health insurance coverage separately from the premiums attributable to the group term life insurance coverage. The contract issued by

L1 is a combination contract as defined in paragraph (g)(1) of this section. Pursuant to paragraph (g)(2)(i) of this section, only the premiums attributable to the group term life insurance coverage (\$50) are subject to the provisions of section 848. The premiums attributable to the cancellable accident and health insurance coverage (\$950) are not subject to the provisions of section 848.

(h) *Group life insurance contract*—(1) *In general.* A life insurance contract (as defined in paragraph (c) of this section) is group life insurance contract if—

(i) The contract is a group life insurance contract under the applicable law;

(ii) The coverage is provided under a master contract issued to the group policyholder, which may be a trust, trustee, or agent;

(iii) The premiums on the contract are reported either as group life insurance premiums or credit life insurance premiums on the insurance company's annual statement (or could be reported as group life insurance premiums or credit life insurance premiums if the company were required to file the annual statement for life and accident and health companies);

(iv) The group affiliation requirement of paragraph (h)(2) of this section is satisfied;

(v) The premiums on the contract are determined on a group basis within the meaning of paragraph (h)(3) of this section; and

(vi) The proceeds of the contract are not payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person. (See paragraph (h)(7) of this section for special rules that apply in determining if this requirement is satisfied.)

(2) *Group affiliation requirement*—(i) *In general.* The group affiliation requirement of section 848(e)(2)(A) and this paragraph (h)(2) is satisfied only if all of the individuals eligible for coverage under the contract constitute a group described in paragraphs (h)(2) (ii) through (viii) of this section.

(ii) *Employee group.* An employee group consists of all of the employees (including statutory employees within the meaning of section 3121(d)(3) and individuals who are treated as employed by a single employer under section 414 (b), (c), or (m)), or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of an employer. For this purpose, the term "employee" includes—

(A) A retired or former employee;

(B) The sole proprietor, if the employer is a sole proprietorship;

(C) A partner of the partnership, if the employer is a partnership;

(D) A director of the corporation, if the employer is a corporation; and
(E) An elected or appointed official of the public body, if the employer is a public body.

(iii) *Debtor group.* A debtor group consists of all of the debtors, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a creditor. For this purpose, the term "debtor" includes a borrower of money or purchaser or lessee of goods, services, or property for which payment is arranged through a credit transaction.

(iv) *Labor union group.* A labor union group consists of all of the members, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a labor union or similar employee organization.

(v) *Association group.* An association group consists of all of the members, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of an association that, at the time the master contract is issued—

(A) Is organized and maintained for purposes other than obtaining insurance;

(B) Has been in active existence for at least two years (including, in the case of a merged or successor association, the years of active existence of any predecessor association); and

(C) Has at least 100 members.

(vi) *Credit union group.* A credit union group consists of all of the members of borrowers, or any class or classes thereof within the meaning of paragraph (h)(2)(x) of this section, of a credit union.

(vii) *Multiple group.* A multiple group consists of two or more groups from any single category described in paragraphs (h)(2) (ii) through (vi) of this section. A multiple group may not include two or more groups from different categories described in paragraph (h)(2) (ii) through (vi) of this section.

(viii) *Certain discretionary groups.* Provided that the contract otherwise satisfies the requirements of paragraph (h)(1) of this section, a contract issued to one of the following discretionary groups is treated as satisfying the group affiliation requirement of this paragraph (h)(2)—

(A) A contract issued to a group consisting of students of one or more universities or other educational institutions;

(B) A contract issued to a group consisting of members or former members of the U.S. Armed Forces;

(C) A contract issued to a group of individuals for the payment of future funeral expenses; and

(D) A contract issued to any other discretionary group as specified by the Commissioner in subsequent guidance published in the Internal Revenue Bulletin. (See § 601.601(d)(2)(ii)(b) of this chapter.)

(ix) *Employees treated as members.* In determining whether the group affiliation requirement of paragraph (h)(2) of this section is satisfied, the employees of a labor union, credit union, or association may be treated as members of a labor union group, a credit union group, or an association group, respectively.

(x) *Class or classes of a group determined without regard to individual health characteristics*—(A) *In general.* A class or classes of a group described in paragraphs (h)(2) (ii) through (viii) of this section may be determined using any reasonable characteristics (for example, amount of insurance, location, or occupation) other than individual health characteristics. The employees of a single employer covered under a policy issued to a multi-employer trust are considered a class of a group described in paragraph (h)(2)(ii) of this section.

(B) *Limitation of coverage based on certain work and age requirements permissible.* A limitation of coverage under a group contract to persons who are actively at work or of a pre-retirement age (for example, age 65 or younger) is not treated as based on individual health characteristics.

(3) *Premiums determined on a group basis*—(1) *In general.* Premiums for a contract are determined on a group basis for purposes of section 848(e)(2)(B) and this paragraph (h) only if the premium charged by the insurance company for each member of the group (or any class thereof) is determined on the basis of the same rates for the corresponding amount of coverage (for example, per \$1,000 of insurance) or on the basis of rates which differ only because of the gender, smoking habits, or age of the member.

(ii) *Exception for substandard premium rates for certain high risk insureds.* Any difference in premium rates is disregarded for purposes of this paragraph (h)(3) if the difference is charged for an individual who was accepted for coverage at a substandard rate prior to January 1, 1993.

(iii) *Flexible premium contracts.* In the case of a group universal life insurance contract, the identical premium requirement is satisfied if the premium rates used by the insurance company in determining the periodic mortality charges applied to the policy account value of any member insured by the contract differ from those of other

members (within the same class) only because of the gender, smoking habits, or age of the member.

(iv) *Determination of actual age.* For purposes of this paragraph (h)(3), determinations of actual age may be made using any reasonable method, provided that this method is applied consistently for all members of the group.

(4) *Underwriting practices used by company.* [Reserved]

(5) *Disqualification of group—(i) In general.* Except as otherwise provided in this paragraph (h)(5), if the requirements of paragraphs (b)(1), (2), and (3) of this section are not satisfied with respect to one or more members of the group, or of a class within a group (within the meaning of paragraph (h)(2)(x) of this section), the premiums for the entire group (or class) are treated as individual life insurance premiums.

(ii) *Exception for de minimis failures.* If the requirements of paragraphs (b)(1), (2), or (3) of this section are not satisfied with respect to one or more members of the group (or class), but the sum of the premiums charged by the insurance company for those individuals is no more than 5 percent of the aggregate premiums for the group (or class), only the premiums charged for those individuals are treated as premiums for an individual life insurance contract.

(6) *Supplemental life insurance coverage.* For purposes of determining whether the requirement in paragraph (h)(3)(i) of this section is satisfied, any supplemental life insurance coverage (including optional coverage for members of the group, their spouses, or their dependent children) is (or is treated as) a separate contract. In determining whether the group affiliation requirement of paragraph (h)(2) of this section is satisfied for the supplemental coverage, a member's spouse and dependent children are treated as members of the group if they are eligible for coverage.

(7) *Special rules relating to the payment of proceeds.* The following rules apply for purposes of section 848(e)(2) and paragraph (h)(1)(vi) of this section.

(i) *Contracts issued to a welfare benefit fund.* If a contract issued to a welfare benefit fund (as defined in section 419) provides for payment of proceeds to the welfare benefit fund, the proceeds of the contract are not considered payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person, provided the proceeds are paid as benefits to the employee or the employee's beneficiary.

(ii) *Credit life insurance contracts.* If a credit life insurance contract provides for payment of proceeds to the insured's creditor, the proceeds of the contract are not treated as payable to or for the benefit of the insured's employer, an organization or association to which the insured belongs, or other similar person, provided the proceeds are applied against an outstanding indebtedness of the insured.

(iii) *"Organization or association" limited to the sponsor of the contract or the group policyholder.* The term "organization or association" means the organization or association that is either the sponsor of the contract or the group policyholder.

(i) *General deductions.* The term "general deductions" is defined in section 848(c)(2). An insurance company determines its general deductions for the taxable year without regard to amounts capitalized or amortized under section 848(a). The amount of a company's general deductions is also determined without regard to the rules of § 1.848-2(f), which apply only for purposes of determining net consideration for reinsurance agreements.

§ 1.848-2 Determination of net premiums.

(a) *Net premiums—(1) In general.* An insurance company must use the accrual method of accounting (as prescribed by section 811(a)(1)) to determine the net premiums with respect to each category of specified insurance contracts. With respect to any category of contracts, net premiums means—

(i) The gross amount of premiums and other consideration (see paragraph (b) of this section); reduced by

(ii) The sum of—

(A) The return premiums (see paragraph (e) of this section); and

(B) The net negative consideration for a reinsurance agreement (other than an agreement described in paragraph (h)(2) of this section). See paragraphs (f) and (g) of this section for rules relating to the determination of net negative consideration.

(2) *Separate determination of net premiums for certain reinsurance agreements.* Net premiums with respect to reinsurance agreements for which an election under paragraph (h)(3) of this section has been made (certain reinsurance agreements with parties not subject to United States taxation) are treated separately and are subject to the rules of paragraph (h) of this section.

(b) *Gross amount of premiums and other consideration—(1) General rule.* The term "gross amount of premiums

and other consideration" means the sum of—

(i) All premiums and other consideration (other than amounts on reinsurance agreements); and

(ii) The net positive consideration for any reinsurance agreement (other than an agreement for which an election under paragraph (h)(3) of this section has been made).

(2) *Items included.* The gross amount of premiums and other consideration includes—

(i) Advance premiums;

(ii) Amounts in a premium deposit fund or similar account, to the extent provided in paragraph (b)(3) of this section;

(iii) Fees;

(iv) Assessments;

(v) Amounts that the insurance company charges itself representing premiums with respect to benefits for its employees (including full-time life insurance salesmen treated as employees under section 7701(a)(20)); and

(vi) The value of a new contract issued in an exchange described in paragraph (c)(2) or (c)(3) of this section.

(3) *Treatment of premium deposits—*

(i) *In general.* An amount in a premium deposit fund or similar account is taken into account in determining the gross amount of premiums and other consideration at the earlier of the time that the amount is applied to, or irrevocably committed to, the payment of a premium on a specified insurance contract. If an amount is irrevocably committed to the payment of a premium on a specified insurance contract, then neither that amount nor any earnings allocable to that amount are included in the gross amount of premiums and other consideration when applied to the payment of a premium on the same contract.

(ii) *Amounts irrevocably committed to the payment of premiums.* Except as provided in paragraph (b)(3)(iii) of this section, an amount in a premium deposit fund or similar account is irrevocably committed to the payment of premiums on a contract only if neither the amount nor any earnings allocable to that amount may be—

(A) Returned to the policyholder or any other person (other than on surrender of the contract); or

(B) Used by the policyholder to fund another contract.

(iii) *Retired lives reserves.* Premiums received by an insurance company under a retired lives reserve arrangement are treated as irrevocably committed to the payment of premiums on a specified insurance contract.

(4) *Deferred and uncollected premiums.* The gross amount of premiums and other consideration does not include deferred and uncollected premiums.

(c) *Policy exchanges.*—(1) *General rule.* Except as otherwise provided in this paragraph (c), an exchange of insurance contracts (including a change in the terms of a specified insurance contract) does not result in any amount being included in the gross amount of premiums and other consideration.

(2) *External exchanges.* If a contract is exchanged for a specified insurance contract issued by another insurance company, the company that issues the new contract must include the value of the new contract in the gross amount of premiums and other consideration.

(3) *Internal exchanges resulting in fundamentally different contracts.*—(i) *In general.* If a contract is exchanged for a specified insurance contract issued by the same insurance company that issued the original contract, the company must include the value of the new contract in the gross amount of premiums and other consideration if the new contract—

(A) Relates to a different category of specified insurance contract than the original contract;

(B) Does not cover the same insured as the original contract; or

(C) Changes the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided in the original contract.

(ii) *Certain modifications treated as not changing the mortality, morbidity, interest, or expense guarantees.* For purposes of paragraph (c)(3)(i)(C) of this section, the following items are not treated as changing the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits provided in the contract—

(A) A change in a temporary guarantee with respect to the amounts to be credited as interest to the policyholder's account, or charged as mortality, morbidity, or expense charges, if the new guarantee applies for a period of ten years or less;

(B) The determination of benefits on annuitization using rates which are more favorable to the policyholder than the permanently guaranteed rates; and

(C) Other items as specified by the Commissioner in subsequent guidance published in the Internal Revenue Bulletin.

(iii) *Exception for contracts restructured by a court supervised rehabilitation or similar proceeding.* No amount is included in the gross amount of premiums and other consideration with respect to any change made to the

interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits of contracts of an insurance company that is the subject of a rehabilitation, conservatorship, insolvency, or similar state proceeding. This treatment applies only if the change—

(A) Occurs as part of the rehabilitation, conservatorship, insolvency, or similar state proceeding; and

(B) Is approved by the state court, the state insurance department, or other state official with authority to act in the rehabilitation, conservatorship, insolvency, or similar state proceeding.

(4) *Value of the contract.*—(i) *In general.* For purposes of paragraph (c)(2) or (c)(3) of this section, the value of the new contract is established through the most recent sale by the company of a comparable contract. If the value of the new contract is not readily ascertainable, the value may be approximated by using the interpolated terminal reserve of the original contract as of the date of the exchange.

(ii) *Special rule for group term life insurance contracts.* In the case of any exchange involving a group term life insurance contract without cash value, the value of the new contract is deemed to be zero.

(iii) *Special rule for certain policy enhancement and update programs.*—(A) *In general.* If the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture benefits of a specified insurance contract are changed pursuant to a policy enhancement or update program, the value of the contract included in the gross amount of premiums and other consideration equals 30 percent of the value determined under paragraph (c)(4) of this section.

(B) *Policy enhancement or update program defined.* For purposes of paragraph (c)(4)(iii)(A) of this section, a policy enhancement or update program means any offer or commitment by the insurance company to all of the policyholders holding a particular policy form to change the interest, mortality, morbidity, or expense guarantees used to determine the contract's nonforfeiture benefits.

(5) *Example.* The principles of this paragraph (c) are illustrated by the following example.

Example. (i) An individual (A) owns a life insurance policy issued by a life insurance company (L1). On January 1, 1993, A purchases additional term insurance for \$250, which is added as a rider to A's life insurance policy. The purchase of the additional term insurance does not change the interest, mortality, morbidity, or expense

guarantees with respect to the nonforfeiture benefits provided by A's life insurance policy.

(ii) A's purchase of the term insurance rider is not considered to result in a fundamentally different contract under paragraph (c)(3) of this section because the addition of the rider did not change the interest, mortality, morbidity, or expense guarantees with respect to the nonforfeiture value of A's original life insurance policy. Therefore, L1 includes only the \$250 received from A in the gross amount of premiums and other consideration.

(d) *Amounts excluded from the gross amount of premiums and other consideration.*—(1) *In general.* The following items are not included in the gross amount of premiums and other consideration—

(i) Items treated by section 808(e) as policyholder dividends that are paid to the policyholder and immediately returned to the insurance company as a premium on the same contract that generated the dividends, including—

(A) A policyholder dividend applied to pay a premium under the contract that generated the dividend;

(B) Excess interest accumulated within the contract;

(C) A policyholder dividend applied for additional coverage (for example, a paid-up addition, extension of the period for which insurance protection is provided, or reduction of the period for which premiums are paid) on the contract that generated the dividend;

(D) A policyholder dividend applied to reduce premiums otherwise payable on the contract that generated the dividend;

(E) An experience-rated refund applied to pay a premium on the group contract that generated the refund; and

(F) An experience-rated refund applied to a premium stabilization reserve held with respect to the group contract that generated the refund;

(ii) Premiums waived as a result of the disability of an insured or the disability or death of a premium payor;

(iii) Premiums considered to be paid on a contract as the result of a partial surrender or withdrawal from the contract, or as a result of the surrender or withdrawal of a paid-up addition previously issued with respect to the same contract; and

(iv) Amounts treated as premiums upon the selection by a policyholder or by a beneficiary of a settlement option provided in a life insurance contract.

(2) *Amounts received or accrued from a guaranty association.* Amounts received or accrued from a guaranty association relating to an insurance company that is subject to an insolvency, delinquency, conservatorship, rehabilitation, or

similar proceeding are not included in the gross amount of premiums and other consideration.

(3) *Exclusion not to apply to dividend accumulations.* For purposes of section 848(d)(3) and paragraph (d)(1) of this section, amounts applied from a dividend accumulation account to pay premiums on a specified insurance contract are not amounts treated as paid to, and immediately returned by, the policyholder.

(e) *Return premiums.* For purposes of section 848(d)(1)(B) and this section, return premiums do not include policyholder dividends (as defined in section 808), claims or benefits payments, or amounts returned to another insurance company under a reinsurance agreement. For the treatment of amounts returned to another insurance company under a reinsurance agreement, see paragraph (f) of this section.

(f) *Net consideration for a reinsurance agreement—(1) In general.* For purposes of section 848, the ceding company and the reinsurer must treat amounts arising from the reinsurance of a specified insurance contract consistently in determining their net premiums. See paragraph (g) of this section for restrictions on the amount of the net negative consideration for any reinsurance agreement that may be taken into account. See paragraph (h) of this section for special rules applicable to reinsurance agreements with parties not subject to United States taxation.

(2) *Net consideration determined by a ceding company—(i) In general.* The net consideration determined by a ceding company for a reinsurance agreement equals—

(A) The gross amount incurred by the reinsurer with respect to the reinsurance agreement, including any ceding commissions, annual allowances, reimbursements of claims and benefits, modified coinsurance reserve adjustments under paragraph (f)(5) of this section, experience-rated adjustments, and termination payments; less

(B) The gross amount of premiums and other consideration incurred by the ceding company with respect to the reinsurance agreement.

(ii) *Net negative and net positive consideration.* If the net consideration is less than zero, the ceding company has net negative consideration for the reinsurance agreement. If the net consideration is greater than zero, the ceding company has net positive consideration for the reinsurance agreement.

(3) *Net consideration determined by the reinsurer—(i) In general.* The net

consideration determined by a reinsurer for a reinsurance agreement equals—

(A) The amount described in paragraph (f)(2)(i)(B) of this section; less

(B) The amount described in paragraph (f)(2)(i)(A) of this section.

(ii) *Net negative and net positive consideration.* If the net consideration is less than zero, the reinsurer has net negative consideration for the reinsurance agreement. If the net consideration is greater than zero, the reinsurer has net positive consideration for the reinsurance agreement.

(4) *Timing consistency required.* For purposes of determining the net consideration of a party for a reinsurance agreement, an income or expense item is taken into account for the first taxable year for which the item is required to be taken into account by either party. Thus, the ceding company and the reinsurer must take the item into account for the same taxable year (or for the same period if the parties have different taxable years).

(5) *Modified coinsurance and funds-withheld reinsurance agreements—(i) In general.* In the case of a modified coinsurance or funds-withheld reinsurance agreement, the net consideration for the agreement includes the amount of any payments or reserve adjustments, as well as any related loan transactions between the ceding company and the reinsurer. The amount of any investment income transferred between the parties as the result of a reserve adjustment or loan transaction is treated as an item of consideration under the reinsurance agreement.

(ii) *Special rule for certain funds-withheld reinsurance agreements.* In the case of a funds-withheld reinsurance agreement that is entered into after November 14, 1991, but before the first day of the first taxable year beginning after December 31, 1991, and is terminated before January 1, 1995, the parties' net consideration in the year of termination must include the amount of the original reserve for any reinsured specified insurance contract that, in applying the provisions of subchapter L, was treated as premiums and other consideration incurred for reinsurance for the taxable year in which the agreement became effective.

(6) *Treatment of retrocessions.* For purposes of this paragraph (f), a retrocession agreement is treated as a separate reinsurance agreement. The party that is relieved of liability under a retrocession agreement is treated as the ceding company.

(7) *Mixed reinsurance agreement.* If a reinsurance agreement includes more than one category of specified insurance

contracts (or specified insurance contracts and contracts that are not specified insurance contracts), the portion of the agreement relating to each category of reinsured specified insurance contracts is treated as a separate agreement. The portion of the agreement relating to reinsured contracts that are not specified insurance contracts is similarly treated as a separate agreement.

(8) *Treatment of policyholder loans.* For purposes of determining the net consideration under a reinsurance agreement, the transfer of a policyholder loan receivable is treated as an item of consideration under the agreement. The interest credited with respect to a policyholder loan receivable is treated as investment income earned directly by the party holding the receivable. The amounts taken into account as claims and benefit reimbursements under the agreement must be determined without reduction for the policyholder loan.

(9) *Examples.* The principles of this paragraph (f) are illustrated by the following examples.

Example 1. On July 1, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement whereby L2 becomes solely liable to the policyholders under the contracts reinsured. L1 and L2 are calendar year taxpayers. Under the assumption reinsurance agreement, L1 agrees to pay L2 \$100,000 for assuming the life insurance contracts, and L2 agrees to pay L1 a \$17,000 ceding commission. Under paragraph (f)(2) of this section, L1 has net negative consideration of (\$83,000) (\$17,000 ceding commission incurred by L2—\$100,000 incurred by L1 for reinsurance). Under paragraph (f)(3) of this section, L2 has net positive consideration of \$83,000. Under paragraph (b)(1)(ii) of this section, L2 includes the net positive consideration in its gross amount of premiums and other consideration.

Example 2. (i) On July 1, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement whereby L1 remains liable to the policyholders under the reinsured contracts. L1 and L2 are calendar year taxpayers. Under the indemnity reinsurance agreement, L1 agrees to pay L2 \$100,000 for reinsuring the life insurance contracts, and L2 agrees to pay L1 a \$17,000 ceding commission. L1 agrees to pay L2 an amount equal to the future premiums on the reinsured contracts. L2 agrees to indemnify L1 for claims and benefits and administrative expenses incurred by L1 while the reinsurance agreement is in effect.

(ii) For the period beginning July 1, 1992, and ending December 31, 1992, the following income and expense items are determined with respect to the reinsured contracts:

Item	Income	Expense
Premiums	\$25,000	.....
Death benefits		\$10,000
Surrender benefits		8,000
Premium taxes and other expenses		2,000
Total		20,000

(iii) Under paragraph (f)(2) of this section, L1's net negative consideration equals (\$88,000), which is determined by subtracting the \$125,000 (\$100,000 + \$25,000) incurred by L1 from the \$37,000 incurred by L2 under the reinsurance agreement (\$17,000 + \$10,000 + \$8,000 + \$2,000). L2's net positive consideration is \$88,000. Under paragraph (b)(1)(ii) of this section, L2 includes the \$88,000 net positive consideration in its gross amount of premiums and other consideration.

Example 3. (i) Assume that the reinsurance agreement referred to in Example 2 is terminated on December 31, 1993. During the period from January 1, 1993 through December 31, 1993, the following income and expense items are determined with respect to the reinsured contracts:

Item	Income	Expense
Premiums	\$45,000	.....
Death benefits		\$18,000
Surrender benefits		6,000
Premium taxes and other expenses		8,000
Total		32,000

(ii) On the termination of the reinsurance agreement, L1 receives a payment of \$70,000 from L2 as consideration for releasing L2 from liability with respect to the reinsured contracts.

(iii) L1's net positive consideration equals \$57,000, which is the excess of the \$102,000 incurred by L2 for the year (\$18,000 + \$8,000 + \$8,000 + \$70,000) over the \$45,000 incurred by L1. L2's net negative consideration is (\$57,000). L1 includes the net positive consideration in its gross amount of premiums and other consideration.

Example 4. (i) On January 1, 1993, an insurance company (L1) enters into a modified coinsurance agreement with another insurance company (L2), covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with an initial reinsurance premium equal to L1's reserves on the reinsured contracts at the inception of the agreement, any new premiums received with respect to the reinsured contracts, any decrease in L1's reserves on the reinsured contracts, and an amount of investment income determined by reference to L1's reserves on the reinsured contracts. L2 is charged for all claims and expenses incurred with respect to the reinsured contracts plus an amount reflecting any increase in L1's reserves. The agreement further provides that cash settlements between the parties are made at the inception and termination of the agreement, as well as at the end of each calendar year while the agreement is in effect. The cash settlement is determined by netting the sum of the

amounts credited to L2 against the sum of the amounts charged to L2 with respect to the reinsured policies. L1's reserves on the reinsured policies at the inception of the reinsurance agreement are \$375,000.

(ii) Under the cash settlement formula, L2 is credited with an initial reinsurance premium equal to L1's reserves on the reinsured policies (\$375,000), but is charged an amount reflecting L1's policy reserve requirements (\$375,000).

(iii) For the period ending December 31, 1993, L2 is also credited and charged the following amounts with respect to the reinsured contracts.

Item	Income	Expense
Premiums	\$100,000	.....
Investment income	39,000	.....
Death benefits .....	.....	\$65,000
Increase in reserves .....	.....	75,000

(iv) Under paragraph (f)(5) of this section, L2's net negative consideration for the 1993 taxable year equals (\$1,000) which is determined by subtracting the sum of the amounts charged to L2 (\$375,000 + \$65,000 + \$75,000 = \$515,000) from the sum of the amounts credited to L2 (\$375,000 + \$100,000 + \$39,000 = \$514,000). L1's net positive consideration for calendar year 1993 equals \$1,000. Under paragraph (b)(1)(ii) of this section, L1 includes the \$1,000 net positive consideration in its gross amount of premiums and other consideration.

Example 5. (i) On January 1, 1993, an insurance company (L1) enters into a coinsurance agreement with another insurance company (L2) covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with an initial reinsurance premium equal to L1's reserves on the effective date of the agreement, any new premiums received on the reinsured contracts, but must indemnify L1 of all claims and expenses incurred with respect to the contracts. As part of the agreement, L2 makes a loan to L1 equal to the amount of the reserves on the reinsured contracts. L1's reserves on the reinsured contracts on the effective date of the agreement are \$375,000. Thus, on the inception date of the reinsurance agreement, L1 transfers to L2 its note for \$375,000 as consideration for reinsurance.

(ii) The reinsurance agreement between L1 and L2 is a funds-withheld reinsurance agreement. Under paragraph (f)(5) of this section, the amount of any loan transaction is taken into account in determining the parties' net consideration. At the inception of the reinsurance agreement, L2 is credited with a reinsurance premium equal to L1's reserves on the reinsured contracts (\$375,000). L2's \$375,000 loan to L1 is treated as an amount returned to L1 under the agreement.

(iii) For the period ending December 31, 1993, L2 is credited and charged the following amounts with respect to the reinsured contracts and the loan transaction with L1.

Item	Income	Expense
Premiums	\$100,000	.....

Item	Income	Expense
Accrued interest	39,000	.....
Death benefits .....	.....	\$65,000
Increase in loan to L1 .....	.....	75,000

(iv) Under paragraph (f)(5) of this section, L2's net negative consideration for the 1993 taxable year equals (\$1,000), which is determined by subtracting the sum of amounts incurred by L2 with respect to death benefits and the loan transaction (\$375,000 + \$65,000 + \$75,000 = \$515,000) from the sum of the amounts credited to L2 as reinsurance premiums and interest on the loan transaction (\$375,000 + \$100,000 + \$39,000 = \$514,000). L1's net positive consideration for calendar year 1993 equals \$1,000. Under paragraph (b)(1)(ii) of this section, L1 includes the \$1,000 net positive consideration in its gross amount of premiums and other consideration.

Example 6. (i) On December 31, 1993, an insurance company (L1) enters into a reinsurance agreement with another insurance company (L2) covering a block of individual life insurance contracts. Both L1 and L2 are calendar year taxpayers. Under the agreement, L2 is credited with L1's reserves on the reinsured contracts on the effective date of the agreement, plus any new premiums received on the reinsured contracts, but must indemnify L1 for all claims and expenses incurred with respect to the contracts. Under the agreement, L1 transfers cash of \$325,000 to L2 plus rights to its policyholder loan receivables on the reinsured contracts (\$50,000). L2 reports the reinsurance agreement by including the transferred policyholder loan receivables as an asset on its books.

(ii) For the period beginning January 1, 1994 and ending December 31, 1994, the following income and expense items are incurred with respect to the reinsured contracts.

Item	Income	Expense
Premiums	\$100,000	.....
Death benefits		\$25,000
Surrender benefits		5,000
Premium taxes and other expenses		8,000
Total		38,000

(iii) These amounts are net of the outstanding policyholder loans held by L2 of \$20,000 with respect to death benefits and \$15,000 with respect to surrender benefits.

(iv) Under paragraph (f)(8) of this section, the transferred policyholder loan receivables are treated as an item of consideration under the reinsurance agreement. In determining the parties' net consideration for the agreement, the transferred policyholder loan receivables (\$50,000) are treated as an item of consideration incurred by L1 under paragraph (f)(2)(i)(B) of this section. Therefore, for the 1993 taxable year, L1 has net negative consideration of (\$375,000). L2 has net positive consideration of \$375,000. Under paragraph (b)(1)(ii) of this section, L2 includes the \$375,000 net positive consideration in its gross amount of premiums and other consideration.

(v) For the 1994 taxable year, L2 has net positive consideration for the reinsurance

agreement of \$62,000 before adjustment for the transferred policyholder loans. Under paragraph (f)(8) of this section, the amounts taken into account as claim and benefit payments must be adjusted by the amount of any transferred policyholder loan receivables which are netted against the reinsurer's claim and benefit reimbursements. Therefore, L2 takes into account \$45,000 (\$25,000+\$20,000-\$45,000) as reimbursements for death benefits, and \$20,000 (\$5,000+\$15,000-\$20,000) as reimbursements for surrender benefits. After adjustment for these items, L2 has net positive consideration of \$27,000, which is determined by subtracting the sum of the amounts charged to L2 (\$45,000+\$20,000+\$8,000=\$73,000) from the sum of the amounts credited to L2 (\$100,000). L1 has net negative consideration of (\$27,000) under the agreement. Under paragraph (b)(1)(ii) of this section, L2 includes the \$27,000 net positive consideration in its gross amount of premiums and other consideration. The amount of any interest earned on the policyholder loan receivables after their transfer to L2 is treated as investment income earned directly by L2, and is not taken into account as an item of consideration under the agreement.

(g) *Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements.*—(1) *In general.* Paragraph (g)(3) of this section provides for a reduction in the amount of net negative consideration that a party to a reinsurance agreement (other than a reinsurance agreement described in paragraph (h)(2) of this section) may take into account in determining net premiums under paragraph (a)(2)(ii) of this section if the party with net positive consideration has a capitalization shortfall (as defined in paragraph (g)(4) of this section). Unless the party with net negative consideration demonstrates that the party with net positive consideration does not have a capitalization shortfall or demonstrates the amount of the other party's capitalization shortfall which is allocable to the reinsurance agreement, the net negative consideration that may be taken into account under paragraph (a)(2)(ii) of this section is zero. However, the reduction of paragraph (g)(3) of this section does not apply to a reinsurance agreement if the parties make a joint election under paragraph (g)(8) of this section. Under the election, the party with net positive consideration capitalizes specified policy acquisition expenses with respect to the agreement without regard to the general deductions limitation of section 848(c)(1).

(2) *Application to reinsurance agreements subject to the interim rules.* In applying this paragraph (g) to a reinsurance agreement that is subject to

the interim rules of § 1.848-3, the term "premiums and other consideration incurred for reinsurance under section 848(d)(1)(B)" is substituted for "net negative consideration," and the term "gross amount of premiums and other consideration under section 848(d)(1)(A)" is substituted for "net positive consideration." If an insurance company has "premiums and other consideration incurred for reinsurance under section 848(d)(1)(B)" and a "gross amount of premiums and other consideration under section 848(d)(1)(A)" for the same agreement, the net of these amounts is taken into account for purposes of this paragraph (g).

(3) *Amount of reduction.* The reduction required by this paragraph (g)(3) equals the amount obtained by dividing—

(i) The portion of the capitalization shortfall (as defined in paragraph (g)(4) of this section) allocated to the reinsurance agreement under paragraph (g)(7) of this section; by

(ii) The applicable percentage set forth in section 848(c)(1) for the category of specified insurance contracts reinsured by the agreement.

(4) *Capitalization shortfall.* A "capitalization shortfall" equals the excess of—

(i) The sum of the required capitalization amounts (as defined in paragraph (g)(5) of this section) for all reinsurance agreements (other than reinsurance agreements for which an election has been made under paragraph (h)(3) of this section); over

(ii) The general deductions allocated to those reinsurance agreements, as determined under paragraph (g)(6) of this section.

(5) *Required capitalization amount.*—

(i) *In general.* The "required capitalization amount" for a reinsurance agreement (other than a reinsurance agreement for which an election has been made under paragraph (h)(3) of this section) equals the amount (either positive or negative) obtained by multiplying—

(A) The net positive or negative consideration for an agreement not described in paragraph (h)(2) of this section, and the net positive consideration for an agreement described in paragraph (h)(2) of this section, but for which an election under paragraph (h)(3) of this section has not been made; by

(B) The applicable percentage set forth in section 848(c)(1) for that category of specified insurance contracts.

(ii) *Special rule with respect to net negative consideration.* Solely for

purposes of computing a party's required capitalization amount under this paragraph (g)(5)—

(A) If either party to the reinsurance agreement is the direct issuer of the reinsured contracts, the party computing its required capitalization amount takes into account the full amount of any net negative consideration without regard to any potential reduction under paragraph (g)(3) of this section; and

(B) If neither party to the reinsurance agreement is the direct issuer of the reinsured contracts, any net negative consideration is deemed to equal zero in computing a party's required capitalization amount except to the extent that the party with the net negative consideration establishes that the other party to that reinsurance agreement capitalizes the appropriate amount.

(6) *General deductions allocable to reinsurance agreements.* An insurance company's general deductions allocable to its reinsurance agreements equals the excess, if any, of—

(i) The company's general deductions (excluding additional amounts treated as general deductions under paragraph (g)(8) of this section); over

(ii) The amount determined under section 848(c)(1) on specified insurance contracts that the insurance company has issued directly (determined without regard to any reinsurance agreements).

(7) *Allocation of capitalization shortfall among reinsurance agreements.* The capitalization shortfall is allocated to each reinsurance agreement for which the required capitalization amount (as determined in paragraph (g)(5) of this section) is a positive amount. The portion of the capitalization shortfall allocable to each agreement equals the amount which bears the same ratio to the capitalization shortfall as the required capitalization amount for the reinsurance agreement bears to the sum of the positive required capitalization amounts.

(8) *Election to determine specified policy acquisition expenses for an agreement without regard to general deductions limitation.*—(i) *In general.* The reduction specified by paragraph (g)(3) of this section does not apply if the parties to a reinsurance agreement make an election under this paragraph (g)(8). The election requires the party with net positive consideration to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation of section 848(c)(1). That party must reduce its deductions under section 805 or section 832(c) by the amount, if any, of the

party's capitalization shortfall allocable to the reinsurance agreement. The additional capitalized amounts are treated as specified policy acquisition expenses attributable to premiums and other consideration on the reinsurance agreement, and are deductible in accordance with section 848(a)(2).

(ii) *Manner of making election.* To make an election under paragraph (g)(8) of this section, the ceding company and the reinsurer must include an election statement in the reinsurance agreement, either as part of the original terms of the agreement or by an addendum to the agreement. The parties must each attach a schedule to their federal income tax returns which identifies the reinsurance agreement for which the joint election under this paragraph (g)(8) has been made. The schedule must be attached to each of the parties' federal income tax returns filed for the later of—

(A) The first taxable year ending after the election becomes effective; or
(B) The first taxable year ending on or after December 29, 1992.

(iii) *Election statement.* The election statement in the reinsurance agreement must—

(A) Provide that the party with net positive consideration for the reinsurance agreement for each taxable year will capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation of section 848(a)(1);

(B) Set forth the agreement of the parties to exchange information pertaining to the amount of net consideration under the reinsurance agreement each year to ensure consistency;

(C) Specify the first taxable year for which the election is effective; and
(D) Be signed by both parties.

(iv) *Effect of election.* An election under this paragraph (g)(8) is effective for the first taxable year specified in the election statement and for all subsequent taxable years for which the reinsurance agreement remains in effect. The election may not be revoked without the consent of the Commissioner.

(9) *Example.* The principles of this paragraph (g) are illustrated by the following examples.

Example 1. (i) On December 31, 1992, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated life insurance company (L2) under an agreement in which L2 becomes solely liable to the policyholders on the reinsured contracts. L1 transfers \$105,000 to L2 as consideration for the reinsurance of the contracts.

(ii) L1 and L2 do not make an election under paragraph (g)(8) of this section to

capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. L2 has no other insurance business, and its general deductions for the taxable year are \$3,500.

(iii) Under paragraph (f)(2) of this section, L1's net negative consideration is (\$105,000). Under paragraph (f)(3) of this section, L2's net positive consideration is \$105,000. Pursuant to paragraph (b)(1)(ii) of this section, L2 includes the net positive consideration in its gross amount of premiums and other consideration.

(iv) The required capitalization amount under paragraph (g)(5) of this section for the reinsurance agreement is \$8,085 (\$105,000 × .077). L2's general deductions, all of which are allocable to the reinsurance agreement with L1, are \$3,500. The \$4,585 difference between the required capitalization amount (\$8,085) and the general deductions allocable to the reinsurance agreement (\$3,500) represents L2's capitalization shortfall under paragraph (g)(4) of this section.

(v) Since L2 has a capitalization shortfall allocable to the agreement, the rules of paragraph (g)(1) of this section apply for purposes of determining the amount by which L1 may reduce its net premiums. Under paragraph (g)(3) of this section, L1 must reduce the amount of net negative consideration that it takes into account under paragraph (a)(2)(ii) of this section by \$59,545 (\$4,585/.077). Thus, of the \$105,000 net negative consideration under the reinsurance agreement, L1 may take into account only \$45,455 as a reduction of its net premiums.

Example 2. The facts are the same as *Example 1*, except that L1 and L2 make the election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. Pursuant to this election, L2 must capitalize as specified policy acquisition expenses an amount equal to \$8,085 (\$105,000 × .077). L1 may reduce its net premiums by the \$105,000 of net negative consideration.

Example 3. (i) A life insurance company (L1) is both a direct issuer and a reinsurer of life insurance and annuity contracts. For 1993, L1's net premiums under section 848(d)(1) for directly issued individual life insurance and annuity contracts are as follows:

Category	Net premiums
Life insurance contracts	\$17,000,000
Annuity contracts	8,000,000

(ii) L1's general deductions for 1993 are \$1,500,000.

(iii) For 1993, L1 is a reinsurer under four separate indemnity reinsurance agreements with unrelated insurance companies (L2, L3, L4, and L5). The agreements with L2, L3, and L4 cover life insurance contracts issued by those companies. The agreement with L5 covers annuity contracts issued by L5. The parties to the reinsurance agreements have not made the election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to these

agreements without regard to the general deductions limitation.

(iv) L1's net consideration for 1993 with respect to its reinsurance agreements is as follows:

Agreement	Net consideration
L2	\$1,200,000
L3	(350,000)
L4	300,000
L5	800,000

(v) To determine whether a reduction under paragraph (g)(3) of this section applies with respect to these reinsurance agreements, L1 must determine the required capitalization amounts for its reinsurance agreements and the amount of its general deductions allocable to these agreements.

(vi) Pursuant to paragraph (g)(5) of this section, the required capitalization amount for each reinsurance agreement is determined as follows:

L2	\$1,200,000 × .077 = \$92,400
L3	(\$350,000) × .077 = (\$26,950)
L4	\$300,000 × .077 = \$23,100
L5	\$800,000 × .0175 = \$139,000

(vii) Thus, the sum of L1's required capitalization amounts on its reinsurance agreements equals \$99,050.

(viii) Pursuant to paragraph (g)(6) of this section, L1 determines its general deductions allocable to its reinsurance agreements. The amount determined under section 848(c)(1) on its directly issued contracts is:

Category:		
Annuity contracts	\$8,000,000 × .0175 =	\$140,000
Life insurance contracts	\$17,000,000 × .077 =	1,309,000
		\$1,449,000

(ix) L1's general deductions allocable to its reinsurance agreements are \$51,000 (\$1,500,000 - \$1,449,000).

(x) Pursuant to paragraph (g)(4) of this section, L1's capitalization shortfall equals \$48,050, reflecting the excess of L1's required capitalization amounts for its reinsurance agreements (\$99,050) over the general deductions allocable to its reinsurance agreements (\$51,000).

(xi) Pursuant to paragraph (g)(7) of this section, the capitalization shortfall of \$48,050 must be allocated between each of L1's reinsurance agreements with net positive consideration in proportion to their respective required capitalization amounts. The allocation of the shortfall between L1's reinsurance agreements is determined as follows:

L2	= \$35,237 (\$48,050 × \$92,400 / \$126,000)
L4	= \$8,809 (\$48,050 × \$23,100 / \$126,000)
L5	= \$4,004 (\$48,050 × \$139,000 / \$126,000)

(xii) Accordingly, the reduction under paragraph (g)(3) of this section that applies to the amount of net negative consideration that may be taken into account by L2, L4, and L5

under paragraph (a)(1)(ii)(B) of this section is determined as follows:

L2=\$457,623 (\$35,237/.077)
L4=\$114,403 (\$8,809/.077)
L5=\$228,800 (\$4,004/.0175)

Example 4. The facts are the same as Example 3, except that L1 and L4 make a joint election under paragraph (g)(8) of this section to capitalize specified policy acquisition expenses with respect to the reinsurance agreement without regard to the general deductions limitation. Pursuant to this election, L1 must reduce its deductions under section 805 by an amount equal to the capitalization shortfall allocable to the reinsurance agreement with L4 (\$8,809). L1 treats the additional capitalized amounts as specified policy acquisition expenses allocable to premiums and other consideration under the agreement. L4 may reduce its net premiums by the \$300,000 net negative consideration. The election by L1 and L4 does not change the amount of the capitalization shortfall allocable under paragraph (g)(7) of this section to the reinsurance agreements with L2 and L5. Thus, the reduction required by paragraph (g)(3) of this section with respect to the amount of the net negative consideration that L2 and L5 may recognize under paragraph (a)(2)(ii) of this section is \$457,623 and \$228,800, respectively.

(h) Treatment of reinsurance agreements with parties not subject to U.S. taxation—(1) In general. Unless an election under paragraph (h)(3) of this section is made, an insurance company may not reduce its net premiums by the net negative consideration for the taxable year (or, with respect to a reinsurance agreement that is subject to the interim rules of § 1.848-3, by the premiums and other consideration incurred for reinsurance) under a reinsurance agreement to which this paragraph (h) applies.

(2) Agreements to which this paragraph (h) applies—(i) In general. This paragraph (h) applies to a reinsurance agreement if, with respect to the premiums and other consideration under the agreement, one party to that agreement is subject to United States taxation and the other party is not.

(ii) Parties subject to U.S. taxation—(A) In general. A party is subject to United States taxation for this purpose if the party is subject to United States taxation either directly under the provisions of subchapter L of chapter 1 of the Internal Revenue Code (subchapter L), or indirectly under the provisions of subpart F of part III of subchapter N of chapter 1 of the Internal Revenue Code (subpart F).

(B) Effect of a closing agreement. If a reinsurer agrees in a closing agreement with the Internal Revenue Service to be subject to tax under rules equivalent to the provisions of subchapter L on its

premiums and other consideration from reinsurance agreements with parties subject to United States taxation, the reinsurer is treated as an insurance company subject to tax under subchapter L.

(3) Election to separately determine the amounts required to be capitalized for reinsurance agreements with parties not subject to U.S. taxation—(i) In general. This paragraph (h)(3) authorizes an insurance company to make an election to separately determine the amounts required to be capitalized for the taxable year with respect to reinsurance agreements with parties that are not subject to United States taxation. If this election is made, an insurance company separately determines a net foreign capitalization amount for the taxable year for all reinsurance agreements to which this paragraph (h) applies.

(ii) Manner of making the election. An insurance company makes the election authorized by this paragraph (h)(3) by attaching an election statement to the federal income tax return (including an amended return) for the taxable year for which the election becomes effective. The election applies to that taxable year and all subsequent taxable years unless permission to revoke the election is obtained from the Commissioner.

(4) Amount taken into account for purposes of determining specified policy acquisition expenses. If for a taxable year an insurance company has a net positive foreign capitalization amount (as defined in paragraph (h)(5)(i) of this section), any portion of that amount remaining after the reduction described in paragraph (h)(7) of this section is treated as additional specified policy acquisition expenses for the taxable year (determined without regard to amounts taken into account under this paragraph (h)). A net positive capitalization amount is treated as an amount otherwise required to be capitalized for the taxable year for purposes of the reduction under section 848(f)(1)(A).

(5) Net foreign capitalization amount—(i) In general. An insurance company's net foreign capitalization amount equals the sum of the foreign capitalization amounts (netting positive and negative amounts) determined under paragraph (h)(5)(ii) of this section for each category of specified insurance contracts reinsured by agreements described in paragraph (h)(2) of this section. If the amount is less than zero, the company has a net negative foreign capitalization amount. If the amount is greater than zero, the company has a net positive foreign capitalization amount.

(ii) Foreign capitalization amounts by category. The foreign capitalization

amount for a category of specified insurance contracts is determined by—

(A) Combining the net positive consideration and the net negative consideration for the taxable year (or, with respect to a reinsurance agreement that is subject to the interim rules of § 1.848-3, by combining the gross amount of premiums and other consideration and the premiums and other consideration incurred for reinsurance) for all agreements described in paragraph (h)(2) of this section which reinsure specified insurance contracts in that category; and

(B) Multiplying the result (either positive or negative) by the percentage for that category specified in section 848(c)(1).

(6) Treatment of net negative foreign capitalization amount—(i) Applied as a reduction to previously capitalized amounts. If for a taxable year an insurance company has a net negative foreign capitalization amount, the negative amount reduces (but not below zero) the unamortized balances of the amounts previously capitalized (beginning with the amount capitalized for the most recent taxable year) to the extent attributable to prior years' net positive foreign capitalization amounts. The amount by which previously capitalized amounts is reduced is allowed as a deduction for the taxable year.

(ii) Carryover of remaining net negative foreign capitalization amount. The net negative foreign capitalization amount, if any, remaining after the reduction described in paragraph (h)(6)(i) of this section is carried over to reduce a future net positive capitalization amount. The remaining net negative foreign capitalization amount may only offset a net positive foreign capitalization amount in a future year, and may not be used to reduce the amounts otherwise required to be capitalized under section 848(e) for the taxable year, or to reduce the unamortized balances of specified policy acquisition expenses from preceding taxable years, with respect to directly written business or reinsurance agreements other than agreements for which the election under paragraph (h)(3) of this section has been made.

(7) Reduction of net positive foreign capitalization amount by carryover amounts allowed. If for a taxable year an insurance company has a net positive foreign capitalization amount, that amount is reduced (but not below zero) by any carryover of net negative foreign capitalization amounts from preceding taxable years. Any remaining net positive foreign capitalization amount is

taken into account as provided in paragraph (h)(4) of this section.

(8) *Examples.* The principles of this paragraph (h) are illustrated by the following examples.

Example 1. (i) On January 1, 1993, a life insurance company (L1) enters into a reinsurance agreement with a foreign corporation (X) covering a block of annuity contracts issued to residents of the United States. X is not subject to taxation either directly under subchapter L or indirectly under subpart F on the premiums for the reinsurance agreement with L1. L1 makes the election under paragraph (b)(3) of this section to separately determine the amounts required to be capitalized for the taxable year with respect to parties not subject to United States taxation.

(ii) For the taxable year ended December 31, 1993, L1 has net negative consideration of (\$25,000) under its reinsurance agreement with X. L1 has no other reinsurance agreements with parties not subject to United States taxation.

(iii) Under paragraph (h)(5) of this section, L1's net negative foreign capitalization amount for the 1993 taxable year equals (\$437.50), which is determined by multiplying L1's net negative consideration on the agreement with X (\$25,000) by the percentage in section 848(c)(1) for the reinsured specified insurance contracts (1.75%). Under paragraph (h)(6)(ii) of this section, L1 carries over the net negative foreign capitalization amount of \$437.50 to future taxable years. The net negative foreign capitalization amount may not be used to reduce the amounts which L1 is required to capitalize on directly written business or reinsurance agreements other than those agreements described in paragraph (h)(7) of this section.

Example 2. (i) The facts are the same as *Example 1* except that L1 terminates its reinsurance agreement with X and receives \$35,000 on December 31, 1994. For the 1994 taxable year, L1 has net positive consideration of \$35,000 under its agreement with X. L1 has no other reinsurance agreements with parties not subject to United States taxation.

(ii) Under paragraph (h)(5) of this section, L1's net positive net foreign capitalization amount for the 1994 taxable year equals \$612.50, which is determined by multiplying the net positive consideration on the agreement with X (\$35,000) by the percentage in section 848(c)(1) for the reinsured specified insurance contracts (1.75%). Under paragraph (h)(4) of this section, L1 reduces the net positive foreign capitalization amount for the taxable year by the net negative foreign capitalization amount carried over from preceding taxable years (\$437.50). After this reduction, L1 includes \$175 (\$612.50 - \$437.50) as specified policy acquisition expenses for the 1994 taxable year.

(i) *Carryover of excess negative capitalization amount—(1) In general.* This paragraph (i) authorizes a carryover of an excess negative capitalization amount (as defined in paragraph (i)(2) of this section) to reduce amounts

otherwise required to be capitalized under section 848. Paragraph (i)(4) provides special rules for the treatment of excess negative capitalization amounts of insolvent insurance companies.

(2) *Excess negative capitalization amount.* The excess negative capitalization amount with respect to a category of specified insurance contracts for a taxable year is equal to the excess of—

(A) The negative capitalization amount with respect to that category; over

(B) The amount that can be utilized under section 848(f)(1).

(3) *Treatment of excess negative capitalization amount.* The excess negative capitalization amount for a taxable year reduces the amounts that are otherwise required to be capitalized by an insurance company under section 848(c)(1) for future years.

(4) *Special rule for the treatment of an excess negative capitalization amount of an insolvent company—(i) When applicable.* This paragraph (i)(4) applies only for the taxable year in which an insolvent insurance company has an excess negative capitalization amount and has net negative consideration under a reinsurance agreement. See paragraph (i)(4)(v) of this section for the definition of "insolvent."

(ii) *Election to forego carryover of excess negative capitalization amount.* At the joint election of the insolvent insurance company and the other party to the reinsurance agreement—

(A) The insolvent insurance company reduces the excess negative capitalization amount which would otherwise be carried over under paragraph (i)(1) of this section by the amount determined under paragraph (i)(4)(iii) of this section; and

(B) The other party reduces the amount of its specified policy acquisition expenses for the taxable year by the amount determined under paragraph (i)(4)(iii) of this section.

(iii) *Amount of reduction to the excess negative capitalization amount and specified policy acquisition expenses.* To determine the reduction to the carryover of an insolvent insurance company's excess negative capitalization amount and the specified policy acquisition expenses of the other party with respect to a reinsurance agreement—

(A) Multiply the net negative consideration for each reinsurance agreement of the insolvent insurer for which there is net negative consideration for the taxable year by the appropriate percentage specified in section 848(c)(1) for the category of

specified insurance contracts reinsured by the agreement;

(B) Sum the results for each agreement;

(C) Calculate the ratio between the results in paragraphs (i)(4)(ii) (A) and (B) of this section for each agreement; and

(D) Multiply that result by the increase in the excess negative capitalization amount of the insolvent insurer for the taxable year.

(iv) *Manner of making election.* To make an election under paragraph (i)(4) of this section, each party to the reinsurance agreement must attach an election statement to its federal income tax return (including an amended return) for the taxable year for which the election is effective. The election statement must identify the reinsurance agreement for which the joint election under this paragraph (i)(4) has been made, state the amount of the reduction to the insolvent insurance company's excess negative capitalization amount that is attributable to the agreement, and be signed by both parties. An election under this paragraph (i)(4) is effective for the taxable year specified in the election statement, and may not be revoked without the consent of the Commissioner.

(v) *Presumptions relating to the insolvency of an insurance company undergoing a court supervised rehabilitation or similar state proceeding.* For purposes of this paragraph (i)(4), an insurance company which is undergoing a rehabilitation, conservatorship, or similar state proceeding shall be presumed to be insolvent if the state proceeding results in—

(A) An order of the state court finding that the fair market value of the insurance company's assets is less than its liabilities;

(B) The use of funds, guarantees, or reinsurance from a guaranty association;

(C) A reduction of the policyholders' available account balances; or

(D) A substantial limitation on access to funds (for example, a partial or total moratorium on policyholder withdrawals or surrenders that applies for a period of 5 years).

(vi) *Example.* The principles of this paragraph (i)(4) are illustrated by the following example.

Example. (i) An insurance company (L1) is the subject of a rehabilitation proceeding under the supervision of a state court. The state court has made a finding that the fair market value of L1's assets is less than its liabilities. On December 31, 1993, L1 transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an assumption reinsurance

agreement whereby L2 becomes solely liable to the policyholders under the contracts reinsured. Under the agreement, L1 agrees to pay L2 \$2,000,000 for assuming the life insurance contracts. This negative net consideration causes L1 to incur an excess negative capitalization amount of \$138,600 for the 1993 taxable year. L1 has no other reinsurance agreements for the taxable year.

(ii) As part of the reinsurance agreement, L1 and L2 agree to make an election under paragraph (i)(4) of this section. Under the election, L1 agrees to forgo the carryover of the \$138,600 excess negative capitalization amount for future taxable years. L2 must include the \$2,000,000 net positive consideration for the reinsurance agreement in its gross amount of premiums and other consideration. L2 reduces its specified policy acquisition expenses for the 1993 taxable year by \$138,600.

(j) *Ceding commissions with respect to reinsurance of contracts other than specified insurance contracts.* A ceding commission incurred with respect to the reinsurance of an insurance contract that is not a specified insurance contract is not subject to the provisions of section 848(g).

(k) *Effective dates—(1) In general.* Unless otherwise specified in this paragraph, the rules of this section are effective for the taxable years of an insurance company beginning after November 14, 1991.

(2) *Reduction in the amount of net negative consideration to ensure consistency of capitalization for reinsurance agreements.* Section 1.848-2(g) (which provides for an adjustment to ensure consistency) is effective for—

(i) All amounts arising under any reinsurance agreement entered into after November 14, 1991; and

(ii) All amounts arising under any reinsurance agreement for taxable years beginning after December 31, 1991, without regard to the date on the reinsurance agreement was entered into.

(3) *Net consideration rules.* Section 1.848-2(f) (which provides rules for determining the net consideration for a reinsurance agreement) applies to—

(i) Amounts arising in taxable years beginning after December 31, 1991, under a reinsurance agreement entered into after November 14, 1991; and

(ii) Amounts arising in taxable years beginning after December 31, 1994, under a reinsurance agreement entered into before November 15, 1991.

(4) *Determination of the date on which a reinsurance agreement is entered into.* A reinsurance agreement is considered entered into at the earlier of—

(i) The date of the reinsurance agreement; or

(ii) The date of a binding written agreement to enter into a reinsurance

transaction if the written agreement evidences the parties' agreement on substantially all material items relating to the reinsurance transaction.

(5) *Special rule for certain reinsurance agreements with parties not subject to U.S. taxation.* The election and special rules in paragraph (h) of this section relating to the determination of amounts required to be capitalized on reinsurance agreements with parties not subject to United States taxation apply to taxable years ending on or after September 30, 1990.

(6) *Carryover of excess negative capitalization amount.* The provisions of paragraph (i) of this section, including the special rule for the treatment of excess negative capitalization amounts of insolvent insurance companies, are affected with respect to amounts arising in taxable years ending on or after September 30, 1990.

§ 1.848-3. Interim rules for certain reinsurance agreements.

(a) *Scope and effective dates.* The rules of this section apply in determining net premiums for a reinsurance agreement with respect to—

(1) Amounts arising in taxable years beginning before January 1, 1992, under a reinsurance agreement entered into after November 14, 1991; and

(2) Amounts arising in taxable years beginning before January 1, 1995, under a reinsurance agreement entered into before November 15, 1991.

(b) *Interim rules.* In determining a company's gross amount of premiums and other consideration under section 848(d)(1)(A) and premiums and other consideration incurred for reinsurance under section 848(d)(1)(B), the general rules of subchapter L of the Internal Revenue Code apply with the adjustments and special rules set forth in paragraph (c) of this section. Except as provided in paragraph (c)(5) of this section (which applies to modified coinsurance transactions), the gross amount of premiums and other consideration is determined without any reduction for ceding commissions, annual allowances, reimbursements of claims and benefits, or other amounts incurred by a reinsurer with respect to insured contracts.

(c) *Adjustment and special rules.* This paragraph sets forth certain adjustments and special rules that apply for reinsurance agreements in determining the gross amount of premiums and other consideration under section 848(d)(1)(A) and premiums and other considerations incurred for reinsurance under section 848(d)(1)(B).

(1) *Assumption reinsurance.* The ceding company must treat the gross amount of consideration incurred with respect to an assumption reinsurance agreement as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The reinsurance must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). For rules relating to the determination and treatment of ceding commissions, see paragraph (c)(3) of this section.

(2) *Reimbursable dividends.* The reinsurer must treat the amount of policyholder dividends reimbursable to the ceding company (other than under a modified coinsurance agreement covered by paragraph (c)(5) of this section) as a return premium under section 848(d)(1)(B). The ceding company must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). The amount of any experience-related refund due the ceding company is treated as a policyholder dividend reimbursable to the ceding company.

(3) *Ceding commissions—(i) In general.* The reinsurer must treat ceding commissions as a general deduction. The ceding company must treat ceding commissions as non-premium related income under section 803(a)(3). The ceding company may not reduce its general deductions by the amount of the ceding commission.

(ii) *Amount of ceding commission.* For purposes of this section, the amount of a ceding commission equals the excess, if any, of—

(A) The increase in the reinsurer's tax reserves resulting from the reinsurance agreement (computed in accordance with section 807(d)); over

(B) The gross consideration incurred by the ceding company for the reinsurance agreement, less any amount incurred by the reinsurer as part of the reinsurance agreement.

(4) *Termination payments.* The reinsurer must treat the gross amount of premiums and other consideration payable as a termination payment to the ceding company (including the tax reserves on the reinsured contracts) as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The ceding company must include the same amount in the gross amount of premiums and other consideration under section 848(d)(1)(A). This paragraph does not apply to modified coinsurance agreements.

(5) *Modified coinsurance agreements.* In the case of a modified coinsurance

agreement, the parties must determine their net premiums on a net consideration basis as described in § 1.848-2(f)(5).

(D) *Examples.* The principles of this section are illustrated by the following examples.

Example 1. On July 1, 1991, an insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policyholder under the contracts reinsured. The tax reserves on the reinsured contracts are \$100,000. Under the assumption reinsurance agreement, L1 pays L2 \$83,000 for assuming the life insurance contracts. Under paragraph (c)(3) of this section, since the increase in L2's tax reserves (\$100,000) exceeds the net consideration transferred by L1 (\$83,000), the reinsurance agreement provides for a ceding commission. The ceding commission equals \$17,000 (\$100,000-\$83,000). Under paragraph (c)(3) of this section, L1 reduces its gross amount of premiums and other consideration for the 1991 taxable year under section 848(d)(1)(B) by the \$100,000 premium incurred for reinsurance, and L2 includes the \$100,000 premium for reinsurance in its gross amount of premiums and other consideration under section 848(d)(1)(A). L1 treats the \$17,000 ceding commission as non-premium related income and section 803(a)(3).

Example 2. On July 1, 1991, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policyholder under the contracts reinsured. The tax reserves on the reinsured contracts are \$100,000. Under the assumption reinsurance agreement, L1 pays L2 \$100,000 for assuming the contracts, and L2 pays L1 a \$17,000 ceding commission. Under paragraph (c)(1) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by \$100,000. L2 includes \$100,000 in its gross amount of premiums and other consideration under section 848(d)(1)(A). Under paragraph (c)(3) of this section, since the increase in L2's tax reserves (\$100,000) exceeds the net consideration transferred by L1, the reinsurance agreement provides for a ceding commission. The ceding commission equals \$17,000 (\$100,000 increase in L2's tax reserves less \$83,000 net consideration transferred by L1). L1 treats the \$17,000 ceding commission as non-premium related income under section 803(a)(3).

Example 3. On July 1, 1991, a life insurance company (L1) transfers a block of individual life insurance contracts to an unrelated insurance company (L2) under an arrangement whereby L2 becomes solely liable to the policyholder under the contracts reinsured. Under the assumption reinsurance agreement, L1 transfers assets of \$105,000 to L2. The tax reserves on the reinsured contracts are \$100,000. Under paragraph (c)(1) of this section, L1 reduces its gross amount of premiums and other consideration

under section 848(d)(1)(B) by \$105,000, and L2 increases its gross amount of premiums and other consideration under section 848(d)(1)(A) by \$105,000. Since the net consideration transferred by L1 exceeds the increase in L2's tax reserves, there is no ceding commission under paragraph (c)(3) of this section.

Example 4. (i) On June 30, 1991, a life insurance company (L1) reinsures 40% of certain individual life insurance contracts to be issued after that date with an unrelated insurance company (L2) under an agreement whereby L1 remains directly liable to the policyholders with respect to the contracts reinsured. The agreement provides that L2 is credited with 40% of any premiums received with respect to the reinsured contracts, but must indemnify L1 for 40% of any claims, expenses, and policyholder dividends. During the period from July 1 through December 31, 1991, L1 has the following income and expense items with respect to the reinsured policies:

Item	Income	Expense
Premiums	\$8,000	
Benefits paid		\$1,000
Commissions		6,000
Policyholder dividends		500
Total		7,500

(ii) Under paragraphs (b) and (c)(2) of this section, L1 includes \$8,200 in its gross amount of premiums and other consideration under section 848(d)(1)(A) (\$8,000 gross premiums on the reinsured contracts plus \$200 of policyholder dividends reimbursed by L2 (\$500 × 40%). L1 reduces its gross amount of premiums and other consideration by \$3,200 (40% × \$8,000) as premiums and other consideration incurred for reinsurance under section 848(d)(1)(B). The benefits and commissions incurred by L1 with respect to the reinsured contracts do not reduce L1's gross amount of premiums and other consideration under section 848(d)(1)(B). L2 includes \$3,200 in its gross amount of premiums and other consideration (40% × \$8,000) and is treated as having paid return premiums of \$200 (the amount of reimbursable dividends paid to L1). L2 is also treated as having incurred the following expenses with respect to the reinsured contracts: \$400 as benefits paid (40% × \$1,000) and \$2,400 as commissions expense (40% × \$6,000). Under paragraph (b) of this section, these expenses do not reduce L2's gross amount of premiums and other consideration under section 848(d)(1)(A).

Example 5. On December 31, 1991, an insurance company (L1) terminates a reinsurance agreement with an unrelated insurance company (L2). The termination applies to a reinsurance agreement under which L1 had ceded 40% of its liability on a block of individual life insurance contracts to L2. Upon termination of the reinsurance agreement, L2 makes a final payment of \$116,000 to L1 for assuming full liability under the contracts. The tax reserves attributable to L2's portion of the reinsured contracts are \$120,000. Under paragraph (c)(4) of this section, L2 reduces its gross amount of premiums and other consideration

under section 848(d)(1)(B) by \$120,000. L1 includes \$120,000 in its gross amount of premiums and other consideration under section 848(d)(1)(A).

Example 6. (i) On June 30, 1991, an insurance company (L1) reinsures 40% of its existing life insurance contracts with an unrelated life insurance company (L2) under a modified coinsurance agreement. For the period July 1, 1991 through December 31, 1991, L1 reports the following income and expense items with respect to L2's 40% share of the reinsured contracts:

Item	Income	Expense
Premiums	\$10,000	
Benefits paid		\$4,000
Policyholder dividends		500
Reserve adjustment		1,500
Total		6,000

(ii) Pursuant to paragraph (c)(5) of this section, L1 reduces its gross amount of premiums and other consideration under section 848(d)(1)(B) by the \$4,000 net consideration for the modified coinsurance agreement (\$10,000-\$6,000). L2 includes the \$4,000 net consideration in its gross amount of premiums and other consideration under section 848(d)(1)(A).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 38. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 39. Section 602.101 (c) is amended by adding the following entries in the table to read as follows:

§ 602.101 OMB Control Numbers.

CFR part or section where identified and described	Current OMB control number
1.848-2(g)(9)	1545-1287
1.848-2(h)(3)	1545-1287
1.848-2(i)(4)	1545-1287

Michael P. Delan,
Acting Commissioner of Internal Revenue.

Approved: November 16, 1992.

Fred T. Goldberg, Jr.,
Assistant Secretary of the Treasury.
[FR Doc. 92-30943 Filed 12-28-92; 8:45am]
BILLING CODE 4030-01-m