

the reserve to an unrelated reinsurer. Z added \$250,000 to the 1985 year end reserve to take into account workers' compensation risks for the 1984 accident year that Z assumed in a reinsurance transaction on September 1, 1986. Z had \$230,000 of 1986 loss payments related to the 1984 accident year of its workers' compensation line, \$60,000 of which was attributable to the reinsurance assumed by Z. At the end of 1986, Z's reserve for the workers' compensation line for the 1984 accident year was \$1,100,000.

(ii) If only paragraph (c)(3)(i) of this section were applied, Z would have a \$460,000 reserve strengthening (\$1,100,000 - (\$1,000,000 - \$230,000 - \$130,000)).

Under paragraph (c)(3)(ii)(B) of this section, however, reserve strengthening does not include the \$250,000 that Z added to the reserve to take into account the reinsurance assumed. Also, none of the \$60,000 of loss payments attributable to the reinsurance assumed in 1986 are taken into account. Accordingly, Z has \$150,000 of reserve strengthening (\$460,000 - \$250,000 - \$60,000). If this is Z's only reserve strengthening or weakening, then the amount that Z must include in income for 1987 under paragraph (e) of this section is \$40,771.05 (\$150,000 × (100% - 72.8193%)). The factor of 72.8193% is the AY+2 factor from the workers' compensation series of discount factors published in Rev. Rul. 87-34.

Example 6. (i) X was a calendar year taxpayer before July 1, 1986, the date on which X became a member of an affiliated group of corporations that files a consolidated return with a June 30 year end. Thus, X had two taxable years beginning in 1986: a short taxable year ending June 30, 1986, and a fiscal taxable year ending June 30, 1987.

(ii) As of the end of 1985, X had undiscounted unpaid losses of \$800,000 in the automobile liability line of business for the 1983 accident year. At the end of the short taxable year, X had reserves of \$700,000 of undiscounted unpaid losses, and on June 30, 1987, had reserves of \$600,000 of undiscounted unpaid losses. During the short taxable year, ending June 30, 1986, X's loss payments for this reserve were \$120,000. During the taxable year ending June 30, 1987, X's loss payments for this reserve were \$180,000. Under paragraph (c)(3)(i) of this section, X has a \$100,000 reserve strengthening: of which \$20,000 (\$700,000 - (\$800,000 - \$120,000)) is attributable to the short taxable year ending June 30, 1986 and \$80,000 (\$600,000 - (\$700,000 - \$180,000)) is attributable to the taxable year ending June 30, 1987.

(iii) The amount of reserve strengthening for this line of business is determined pursuant to the principles of paragraph (c)(2) of this section.

[T.D. 8433, 57 FR 40845, Sept. 8, 1992; 57 FR 48563, Oct. 27, 1992; 57 FR 57531, Dec. 4, 1992]

§ 1.846-4 Effective/applicability date.

(a) *In general.* Sections 1.846-1 through 1.846-3 apply to taxable years beginning after December 31, 1986.

(b) *Section 338 election.* Section 1.846-2(d) applies to section 846(e) elections made with regard to a qualified stock purchase made on or after April 10, 2006.

[T.D. 9257, 71 FR 18006, Apr. 10, 2006, as amended by T.D. 9377, 73 FR 3873, Jan. 23, 2008]

§ 1.846-4T Effective dates (temporary).

(a) [Reserved]. For further guidance, see § 1.846-2(a).

(b) *Section 338 election.* Section 1.846-2(d) applies to section 846(e) elections made with regard to a qualified stock purchase made on or after April 10, 2006.

[T.D. 9257, 71 FR 18006, Apr. 10, 2006]

§ 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.
 - (1) 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.

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(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.

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(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.

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(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 payments.

(5) Modified coinsurance agreements.

(d) Examples.

[T.D. 8456, 57 FR 61818, Dec. 29, 1992]

§ 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 or 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) (i) 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—(i) 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 (h)(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 (h) (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.

[T.D. 8456, 57 FR 61819, Dec. 29, 1992; 58 FR 9245, Feb. 19, 1993]

§ 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 values 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

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\$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 + \$6,000 + \$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
Accrued interest	39,000
Death benefits		\$65,000

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Item	Income	Expense
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 para-

graph (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 ($\$105,000 \times .077$). 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	600,000

(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.....	\$600,000×.0175=\$10,500

(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:

REQUIRED CAPITALIZATION AMOUNT

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 (\$48,050×10,500/126,000)

(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(a) 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 (h)(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)(2) 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 1984 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 re-

insurance 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)(iii) (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 in-

clude 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 which 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.

[T.D. 8456, 57 FR 61821, Dec. 29, 1992; 58 FR 7987, Feb. 11, 1993; 59 FR 947, Jan. 7, 1994]

§ 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 reinsured 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 policy holder 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

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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).

[T.D. 8456, 57 FR 61829, Dec. 29, 1992]

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