compensation in 1960). For the purpose of this subparagraph, if a person other than the employee dies holding an unexercised option at a time when the employee is still living, the transfer which results by reason of the death of such person is a transfer in a transaction which is not at arm's length.

(5) If there is granted an option to which this section applies, and the employee dies before realizing the compensation in accordance with the rules of this paragraph, income having the character of compensation is realized at the time and in the amount determined under this paragraph by the person who transfers or exercises the option, or the person who receives the property subject to a restriction which has a significant effect on its value. For example, this subparagraph is applicable:

(i) When an option not having a readily ascertainable fair market value is granted to an employee, and he dies before transferring or exercising the option,

(ii) When an option not having a readily ascertainable fair market value is granted to the employee, and he dies after the transfer of the option in a transaction which is not at arm's length, but before the option is exercised, or

(iii) When an option not having a readily ascertainable fair market value is granted to another person, and the employee dies before realizing all of the compensation which would result from any transfer or exercise of the option. If the option is one which was granted to the employee and he dies before transferring or exercising the option, the option shall be considered a right to receive income in respect of a decedent to which the rules of section 691 apply. In any such case, if the option is transferred, section 691 provides that the amount received for such transfer or the fair market value of the property transferred at the time of transfer, whichever is greater, is income realized at the time of such transfer. Moreover, if a transfer is subject to this rule, it will be treated as a transfer in an arm's length transaction for the purpose of this paragraph.

(6) If an option to which this section applies is exercised in part and transferred in part, the rules of this paragraph shall be applied as if there were two options—one exercised and one transferred.

(7) Notwithstanding the other provisions of this paragraph, if this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a restricted stock option, the taxable year of the employee for which he is required to include in his gross income the compensation resulting from such option is determined under section 421 (f) and paragraph (e) of § 1.421–5.

(e) *Basis.* (1) If an option to which this section applies is exercised by the person to whom it was granted, such person's basis for the property so acquired shall be increased by any amount that is includible in the gross income of the employee under paragraph (d) of this section. If such person transfers such property to a person whose basis is the same as the transferor's basis, such transferee's basis shall also reflect the adjustment made by this paragraph. However, if such property is transferred by either of such persons at death so that its basis is determined under section 1014, the basis so determined shall not be increased by reason of this paragraph.

(2) If an option to which this section applies is transferred in a transaction which is not at arm's length, the transferee who exercises the option shall increase his basis for the property so acquired by any amount that is includible in the gross income of the employee at the time such transferee acquires the property.

(3) If an option to which this section applies is transferred in a transaction which is at arm's length, the basis of the property acquired by an exercise of the option shall not be increased by reason of any amount that is includible in the gross income of the employee under this section.

(4) If an option to which this section applies has a readily ascertainable fair market value at the time it is granted, the basis of such option includes any amount includible in gross income of the employee under paragraph (c) of this section.

(f) *Deductions.* If the employer grants an option to which this section applies, the employer of the employee in connection with whose employment the option is granted is considered to have paid compensation to such employee at the same time and in the same amount as such employee is considered under paragraph (c) or (d) of this section to have realized compensation. The deductibility of the amount considered so paid is determined under section 162 or other provision of the Code which is applicable to such a payment. Whether such amount may be deducted in the taxable year considered so paid, or whether such amount is a capital expenditure which is not deductible or which may be amortized, depends upon the nature of the transaction involved and the facts and circumstances of each case. If this section is applicable because of a disqualifying disposition of stock acquired by the exercise of a restricted stock option, the employer's taxable year for which such compensation is deductible is determined under section 421(f) and paragraph (e) of § 1.421–5.

(Section 7805 of the Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805)

[F.R. Doc. 61–528; Filed, Jan. 19, 1961; 8:48 a.m.]

[T.D. 6534]

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

Carryover of Excess Contributions to Certain Taxable Years of Employer

On November 26, 1960, notice of proposed rule making with respect to the amendments of the Income Tax Regulations (26 CFR Part I) under section 404 of the Internal Revenue Code of 1954 to provide rules with respect to the carryover of excess contributions to certain taxable years of the employer was published in the FEDERAL REGISTER (25 F.R. 11235). After consideration of all such relevent matter as was presented by interested persons regarding the rules proposed, the amendments of the regulations as so published are hereby adopted without change. In addition, in order to provide that rules similar to those contained in such amendments are to be followed in the case of taxable years to which 26 CFR Parts 29 and 39 (Regulations 111 and 118) apply, paragraph 9 as set forth below is included in this Treasury decision.

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 16, 1961.

FRED C. SCRIBNER, Jr.,
Acting Secretary of the Treasury.

PARAGRAPH 1. Paragraph (a) of § 1.404 (a)–3 is amended to read as follows:

§ 1.404(a)–3 Contributions of an employer to or under an employees' pension trust or annuity plan that meets the requirements of section 401(a); application of section 404 (a)(1).

(a) If contributions are paid by an employer to or under a pension trust or annuity plan for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a) (1) or (2) if the further conditions provided therein are also satisfied. As used in this section, a "pension trust" means a trust forming part of a pension plan and an "annuity plan" means a pension plan under which retirement benefits are provided under annuity or insurance contracts without a trust. This section is also applicable to contributions to a foreign situs pension trust which could qualify for exemption under section 501(a) except that it is not created or organized and maintained in the United States. For the meaning of "pension plan" as used in this section, see paragraph (b)(1)(i) of § 1.401–1. Where disability pensions, insurance, or survivorship benefits incidental and directly related to the retirement benefits under a pension or annuity plan are provided for the employees or their beneficiaries by contributions under the plan, deductions on account of such incidental benefits are also covered under section 404(a) (1) or (2). See paragraph (a) (3) of § 1.402(a)–1 as to taxability to employees of cost of incidental insurance protection. In order to be deductible under section 404(a)(1), contributions to a pension trust must be paid in a taxable year of the employer which ends with or within a year of the trust for which it is exempt under section 501(a). Contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). See § 1.404(a)–7 for rules relating to the limitation on the amount deductible in such a succeeding taxable year of the employer. See § 1.404(a)–8 as to conditions for deductions under section 404

(a)(2) in the case of an annuity plan. In either case, the deductions are also subject to further limitations provided in section 404(a)(1). The limitations provided in section 404(a)(1) are, with an exception provided for certain years under subparagraph (A) thereof (see § 1.404(a)–4), based on the actuarial costs of the plan.

PAR. 2. Section 1.404(a)–4 is amended (A) by revising paragraph (a), (B) by revising paragraph (b), and (C) by adding a new paragraph (d) at the end thereof. These amended and added provisions read as follows:

§ 1.404(a)–4 Pension and annuity plans; limitations under section 404 (a)(1)(A).

(a) Subject to the applicable general conditions and limitations (see § 1.404 (a)–3), the initial limitation under section 404(a)(1)(A) is 5 percent of the compensation otherwise paid or accrued during the taxable year to all employees under the pension or annuity plan. This initial 5-percent limitation applies to the first taxable year for which a deduction is allowed for contributions to or under such a plan and also applies to any subsequent year (other than one described in paragraph (d) of this section) for which the 5-percent figure is not reduced as provided in this section. For years to which the initial 5-percent limitation applies, no adjustment on account of prior experience is required. If the contributions do not exceed the initial 5-percent limitation in the first taxable year to which this limitation applies, the taxpayer need not submit actuarial data for such year.

(b) For the first taxable year following the first year to which the initial 5-percent limitation applies, and for every fifth year thereafter, or more frequently where preferable to the taxpayer, the taxpayer shall submit with his return an actuarial certification of the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan with a statement explaining all the methods, factors, and assumptions used in determining such amount. This amount may be determined as the sum of (1) the unfunded past service cost as of the beginning of the year, and (2) the normal cost for the year. Such costs shall be determined by methods, factors, and assumptions appropriate as a basis of limitations under section 404(a)(1)(C). Whenever requested by the district director, a similar certification and statement shall be submitted for the year or years specified in such request. The district director will make periodical examinations of such data at not less than 5-year intervals. Based upon such examinations the Commissioner will reduce the limitation under section 404 (a)(1)(A) below the 5-percent limitation for the years with respect to which he finds that the 5-percent limitation exceeds the amount reasonably necessary to provide the remaining unfunded cost of past and current service credits of all employees under the plan. Where the limitation is so reduced, the reduced limitation shall apply until the Commissioner finds that a subsequent actuarial valuation shows a change to be necessary. Such subsequent valuation may be made by the taxpayer at any time and submitted to the district director with a request for a change in the limitation. See, however, paragraph (d) of this section with respect to taxable years to which the limitation under section 404 (a)(1)(A) does not apply.

* * * * *

(d) The limitation under section 404 (a)(1)(A) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See § 1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

PAR. 3. Section 1.404(a)–5 is amended (A) by revising paragraph (a) and (B) by adding a new paragraph (e) at the end thereof. The amended and added provisions read as follows:

§ 1.404(a)–5 Pension and annuity plans; limitations under section 404 (a)(1)(B).

(a) Subject to the applicable general conditions and limitations (see § 1.404 (a)–3), under section 404(a)(1)(B), deductions may be allowed to the extent of limitations based on costs determined by distributing the remaining unfunded cost of the past and current service credits with respect to all employees covered under the trust or plan as a level amount or level percentage of compensation over the remaining service of each such employee except that, as to any three individuals with respect to whom more than 50 percent of such remaining unfunded cost is attributable, the remaining unfunded cost attributable to such individuals shall be distributed evenly over a period of at least five taxable years. See, however, paragraph (e) of this section with respect to taxable years to which the limitation under section 404(a)(1)(B) does not apply.

* * * * *

(e) The limitation under section 404(a)(1)(B) shall not be used for purposes of determining the amount deductible for a taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated. See § 1.404(a)–7 for rules relating to the limitation which is applicable for purposes of determining the amount deductible for such a taxable year of the employer.

PAR. 4. Section 1.404(a)–6 is amended to read as follows:

§ 1.404(a)–6 Pension and annuity plans; limitations under section 404 (a)(1)(C).

(a) *Application to a taxable year of the employer which ends with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2).* (1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust for which it is exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2). See paragraph (b) of this section for rules relating to the limitation under section 404(a)(1)(C) for other taxable years of the employer.

(2) Subject to the applicable general conditions and limitations (see § 1.404 (a)–3), in lieu of amounts deductible under the limitations of section 404(a)(1)(A) and section 404(a)(1)(B), deductions may be allowed under section 404(a)(1)(C) to the extent of limitations based on normal and past service or supplementary costs of providing benefits under the plan. "Normal cost" for any year is the amount actuarially determined which would be required as a contribution by the employer in such year to maintain the plan if the plan had been in effect from the beginning of service of each then included employee and if such costs for prior years had been paid and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. Past service or supplementary cost at any time is the amount actuarially determined which would be required at such time to meet all the future benefits provided under the plan which would not be met by future normal costs and employee contributions with respect to the employees covered under the plan at such time.

(3) The limitation under section 404(a)(1)(C) for any taxable year to which this paragraph applies is the sum of normal cost for the year plus an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. For this purpose, the normal cost may be determined by any generally accepted actuarial method and may be expressed either as (i) the aggregate of level amounts with respect to each employee covered under the plan, (ii) a level percentage of payroll with respect to each employee covered under the plan, or (iii) the aggregate of the single premium or unit costs for the unit credits accruing during the year with respect to each employee covered under the plan, provided, in any case, that the method is reasonable in view of the provisions and coverage of the plan, the funding medium, and other applicable considerations. The limitation may include one-tenth of the past service or supplementary cost as of the date the provisions resulting in such cost were put into effect, but it is subject to adjustments for prior favorable experience.

See § 1.404(a)–3. In any case, past service or supplementary costs shall not be included in the limitation for any year in which the amount required to fund fully or to purchase such past service or supplementary credits has been deducted, since no deduction is allowable for any amount (other than the normal cost) which is paid in after such credits are fully funded or purchased.

(b) *Application to a taxable year of the employer which does not end with or within a taxable year of the pension trust or annuity plan for which it is exempt under section 501(a) or meets the requirements of section 404(a)(2).*

(1) The rules in this paragraph are applicable with respect to the limitation under section 404(a)(1)(C) for taxable years of the employer which end with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which end after the trust or plan has terminated. Since contributions paid in such taxable years of the employer are not deductible under section 404(a) (1) or (2) (except as provided in section 404(a)(6)), the limitation under section 404(a)(1)(C) for such taxable years relates only to the amount of any excess contributions that may be carried over to such taxable years under section 404(a)(1)(D).

(2) Subject to the applicable general conditions and limitations (see § 1.404 (a)–3), deductions may be allowed under section 404(a)(1)(C) for taxable years of the employer to which this paragraph applies to the extent of limitations based on past service or supplementary costs of providing benefits under the plan. For definition of the "past service or supplementary cost at any time", see paragraph (a)(2) of this section.

(3) The limitation under section 404 (a)(1)(C) for any taxable year to which this paragraph applies is an amount not in excess of one-tenth of the past service or supplementary cost as of the date the past service or supplementary credits are provided under the plan. The limitation under section 404(a)(1)(C) is subject, however, to adjustments for prior favorable experience. In any case, no amounts are deductible under section 404(a)(1)(C) for any year to which this paragraph applies if the amount required to fund fully or to purchase the past service or supplementary credits has been deducted in prior taxable years of the employer.

PAR. 5. Section 1.404(a)–7 is amended to read as follows:

§ 1.404(a)–7 Pension and annuity plans; contributions in excess of limitations under section 404(a)(1); application of section 404(a)(1)(D).

When contributions paid by an employer in a taxable year to or under a pension or annuity plan exceed the limitations applicable under section 404(a)(1) but otherwise satisfy the conditions for deduction under section 404(a) (1) or (2), then in accordance with section 404(a)(1)(D), the excess contributions are carried over and are deductible in succeeding taxable years of the employer in order of time pursuant to the following rules:

(a) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust for which it is exempt under section 501(a), or, in the case of an annuity plan, during which it meets the requirements of section 404(a)(2), such excess contributions are deductible to the extent of the difference between the amount paid and deductible in such succeeding taxable year and the limitation applicable to such year under section 404(a)(1)(A), (B), or (C).

(b) In the case of a succeeding taxable year of the employer which ends with or within a taxable year of the pension trust during which it is not exempt under section 501(a), or, in the case of an annuity plan, during which it does not meet the requirements of section 404(a)(2), or which ends after the trust or plan has terminated, such excess contributions are deductible to the extent of the limitation applicable to such year under section 404(a)(1)(C) (see paragraph (b) of § 1.404(a)–6).

The provisions of section 404(a)(1)(D) are to be applied before giving effect to the provisions of section 404(a)(7) for any year. The carryover provisions of section 404(a)(1)(D), before effect has been given to section 404(a)(7), may be illustrated by the following example for a plan put into effect in a taxable year ending December 31, 1954:

Taxable Year Ending Dec. 31, 1954

Amount of contributions paid in year	$100,000
Limitation applicable to year	60,000
Amount deductible for year	60,000
Excess carried over to succeeding years	40,000

Taxable Year Ending Dec. 31, 1955

Amount of contributions paid in year	$25,000
Carried over from previous years	40,000
Total deductible subject to limitation	65,000
Limitation applicable to year	50,000
Amount deductible for year	50,000
Excess carried over to succeeding years	15,000

Taxable Year Ending Dec. 31, 1956

Amount of contributions paid in year	$10,000
Carried over from previous years	15,000
Total deductible subject to limitation	25,000
Limitation applicable to year	45,000
Amount deductible for year	25,000
Excess carried over to succeeding years	None

PAR. 6. Paragraph (a)(2) of § 1.404 (a)–8 is amended to read as follows:

§ 1.404(a)–8 Contributions of an employer under an employees' annuity plan which meets the requirements of section 401(a); application of section 404(a)(2).

(a) * * *

(2) The contributions must be paid in a taxable year of the employer which ends with or within a year of the plan for which it meets the applicable requirements with respect to discrimination set out in section 401(a) (3), (4), (5), and (6). See §§ 1.401–3 and 1.401–4. Contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with section 404(a)(1)(D), whether or not such succeeding taxable year ends with or within a taxable year of the plan for which it meets the requirements set out in section 401(a) (3), (4), (5), and (6). The requirements set out in section 401(a) (3), (4), (5), and (6) are considered to be satisfied for the period beginning with the date on which an annuity plan was put into effect and ending with the fifteenth day of the third month following the close of the taxable year of the employer in which the plan was put into effect, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period. See section 401(b) and § 1.401–5. It should be noted that the period in which a plan may be amended to qualify under section 401(b) ends before the date taxpayers, other than corporations, are required to file income tax returns.

PAR. 7. Section 1.404(a)–9 is amended (A) by revising paragraphs (a), (b), (c), (d), and (e) and (B) by revising the heading of the illustration in paragraph (g). These amended provisions read as follows:

§ 1.404(a)–9 Contributions of an employer to an employees' profit-sharing or stock bonus trust that meets the requirements of section 401(a); application of section 404(a)(3)(A).

(a) If contributions are paid by an employer to a profit-sharing or stock bonus trust for employees and the general conditions and limitations applicable to deductions for such contributions are satisfied (see § 1.404(a)–1), the contributions are deductible under section 404(a)(3)(A) if the further conditions provided therein are also satisfied. In order to be deductible under the first, second, or third sentence of section 404 (a)(3)(A), the contributions must be paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a) and the trust must not be designed to provide retirement benefits for which the contributions can be determined actuarially. Excess contributions paid in such a taxable year of the employer may be carried over and deducted in a succeeding taxable year of the employer in accordance with the third sentence of section 404(a) (3)(A), whether or not such succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a). This section is also applicable to contributions to a foreign situs profit-sharing or stock bonus trust which could qualify for exemption under section 501(a) except that

it is not created or organized and maintained in the United States.

(b) The amount of deductions under section 404(a)(3)(A) for any taxable year is subject to limitations based on the compensation otherwise paid or accrued by the employer during such taxable year to employees who are beneficiaries under the plan. For purposes of computing this limitation, the following rules are applicable:

(1) In the case of a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, in such taxable year of the employer, are beneficiaries of the trust funds accumulated under the plan.

(2) In the case of a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated, the limitation shall be based on the compensation otherwise paid or accrued by the employer during such taxable year of the employer to the employees who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), were beneficiaries of the trust funds accumulated under the plan.

For purposes of this paragraph, "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable under a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2). The limitations under section 404(a)(3)(A) apply to the total amount deductible for contributions to the trust regardless of the manner in which the funds of the trust are invested, applied, or distributed, and no other deduction is allowable on account of any benefits provided by contributions to the trust or by the funds thereof. Where contributions are paid to two or more profit-sharing or stock bonus trusts satisfying the conditions for deduction under section 404(a)(3)(A), such trusts are considered as a single trust in applying these limitations.

(c) The primary limitation on deductions for a taxable year is 15 percent of the compensation otherwise paid or accrued by the employer during such taxable year to the employees who are beneficiaries under the plan. See paragraph (b) of this section for rules for determining who are the beneficiaries under the plan.

(d) In order that the deductions may average 15 percent of compensation otherwise paid or accrued over a period of years, where contributions in some taxable year are less than the primary limitation but contributions in some succeeding taxable year exceed the primary limitation, deductions in each succeeding year are subject to a secondary limitation instead of to the primary limitation. The secondary limitation for any year is equal to the lesser of (1) twice the primary limitation for the year, or (2) any excess of (i) the aggregate of the primary limitations for the year and for all prior years over (ii) the aggregate of the deductions allowed or allowable under the limitations provided in section 404(a)(3)(A) for all prior years. Since contributions paid into a profit-sharing or stock bonus trust are deductible under section 404(a)(3)(A) only if they are paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a), the secondary limitation described in this paragraph is not applicable with respect to determining amounts deductible for a taxable year of the employer which ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or which ends after the trust has terminated. See paragraph (e) of this section for rules relating to amounts which are deductible in such a taxable year.

(e) In any case when the contributions in a taxable year exceed the amount allowable as a deduction for the year under section 404(a)(3)(A), the excess is deductible in succeeding taxable years, in order of time, in accordance with the following limitations:

(1) If the succeeding taxable year ends with or within a taxable year of the trust for which it is exempt under section 501(a), such excess is deductible in any such succeeding taxable year in which the contributions are less than the primary limitation for that year; but the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such year, or (ii) the sum of the contributions in such year and the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

(2) If the succeeding taxable year ends with or within a taxable year of the trust during which it is not exempt under section 501(a), or if such succeeding taxable year ends after the trust has terminated, the total deduction for such succeeding taxable year cannot exceed the lesser of (i) the primary limitation for such succeeding taxable year, or (ii) the excess contributions not deducted under the limitations of section 404(a)(3)(A) for prior years.

In no case, however, are excess contributions deductible in a succeeding taxable year if such contributions were not paid (or deemed to have been paid under section 404(a)(6)) in a taxable year of the employer which ends with or within a taxable year of the trust for which it is exempt under section 501(a).

* * * * *

(g) * * *

Illustration of provisions of section 404(a)(3)(A) for a plan put into effect in the taxable (calendar) year 1954, before giving effect to section 404(a)(7) (all figures represent thousands of dollars and all taxable (calendar) years are years which end with or within a taxable year of the trust for which it is exempt under section 501(a))

* * * * *

PAR. 8. Section 1.404(a)-13 is amended (A) by revising paragraph (a) and (B) by changing the heading of the illustration in paragraph (c). These amended provisions read as follows:

§ 1.404(a)-13 Contributions of an employer where deductions are allowable under section 404(a)(1) or (2) and also under section 404(a)(3); application of section 404(a)(7).

(a) Where deductions are allowable under section 404(a)(1) or (2) on account of contributions under a pension or annuity plan and deductions are also allowable under section 404(a)(3) for the same taxable year on account of contributions to a profit-sharing or stock bonus trust, the total deductions under these sections are subject to the provisions of section 404(a)(7) unless no employee who is a beneficiary under the trusts or plans for which deductions are allowable under section 404(a)(1) or (2) is also a beneficiary under the trusts for which deductions are allowable under section 404(a)(3). The provisions of section 404(a)(7) apply only to deductions for overlapping trusts or plans, i.e., for all trusts or plans for which deductions are allowable under section 404(a)(1), (2), or (3) except (1) any trust or plan for which deductions are allowable under section 404(a)(1) or (2) and which does not cover any employee who is also covered under a trust for which deductions are allowable under section 404(a)(3), and (2) any trust for which deductions are allowable under section 404(a)(3) and which does not cover any employee who is also covered under a trust or plan for which deductions are allowable under section 404(a)(1) or (2). The limitations under section 404(a)(7) for any taxable year of the employer are based on the compensation otherwise paid or accrued during the year by the employer to all employees who, in such year, are beneficiaries of the funds accumulated under one or more of the overlapping trusts or plans. For purposes of the preceding sentence, if the taxable year of the employer with respect to which the limitation is being computed ends with or within a taxable year of any of the overlapping trusts or plans during which any such trust is not exempt under section 501(a) or, in the case of a plan, during which it does not meet the requirements of section 404(a)(2), or if such taxable year of the employer ends after any such trust or plan has terminated, then, with respect to such trust or plan, those employees, and only those employees, who, at any time during the one-year period ending on the last day of the last calendar month during which the trust was exempt under section 501(a), or the plan met the requirements of section 404(a)(2), were beneficiaries of the funds accumulated under such trust or plan shall be considered the beneficiaries of such trust or plan in the taxable year of the employer with respect to which the limitation is being computed. For purposes of this paragraph, "compensation otherwise paid or accrued" means all of the compensation paid or accrued except that for which a deduction is allowable un-

der a plan that qualifies under section 401(a), including a plan that qualifies under section 404(a)(2).

* * * * *

(c) * * *

Illustration of application of provisions of section 404(a)(7) and of treatment of carryovers for overlapping pension and profit-sharing trusts put into effect in 1954 and covering the same employees (all figures represent thousands of dollars and all taxable (calendar) years of the employer are years which end with or within a taxable year of the trust for which it is exempt under section 501(a))

* * * * *

PAR. 9. The amendments of the Income Tax Regulations under section 404 of the Internal Revenue Code of 1954, covering taxable years beginning after December 31, 1953, and ending after August 16, 1954, set forth in this Treasury decision, are hereby made applicable to taxable years covered by 26 CFR Parts 29 and 39 (Regulations 111 and 118).

Because Paragraph 9 of this Treasury decision does not relate to new or different substantive rules but merely provides that the amendments made by the other paragraphs of this Treasury decision (which were published with notice of proposed rule making) shall apply to taxable years covered by 26 CFR Parts 29 and 39 (Regulations 111 and 118), it is found that it is unnecessary to issue this paragraph with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, approved June 11, 1946, or subject to the effective date limitation under section 4(c) of that Act.

(Sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805; secs. 62 and 3791 of the Internal Revenue Code of 1939; 53 Stat. 32, 467; 26 U.S.C. 62, 3791)

[F.R. Doc. 61-511; Filed, Jan. 19, 1961; 8:46 a.m.]

[T.D. 6539]

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

"Dollar-Value" LIFO Method

On December 1, 1960, notice of proposed rule making was published in the FEDERAL REGISTER (25 F.R. 12293) regarding an amendment of the Income Tax Regulations (26 CFR Part 1) under section 472 of the Internal Revenue Code of 1954 to prescribe rules under the so-called "dollar-value" LIFO method. After considering all relevant matter as was presented by interested persons regarding the proposed rules, the regulations as so proposed are hereby adopted for taxable years beginning after December 31, 1953, and ending after August 16, 1954, except where otherwise provided, and subject to the following changes:

Section 1.472-8 is amended by revising subparagraph (1), subdivision (i) of subparagraph (2), and subdivisions (i)(*a*), (i)(*c*), and (ii) of subparagraph (3) of paragraph (b); paragraph (d); subparagraph (1), and example (2) of subdivision (v) of subparagraph (2) of paragraph (e); subparagraph (1) of paragraph (f); and subparagraph (1) of paragraph (h).

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 16, 1961.

FRED C. SCRIBNER, Jr.,
Acting Secretary of the Treasury.

In order to prescribe rules under the so-called "dollar-value" LIFO method, such regulations are amended as follows:

PARAGRAPH 1. Paragraph (1) of § 1.472-1 is amended to read as follows:

§ 1.472-1 Last-in, first-out inventories.

* * * * *

(1) If a taxpayer uses consistently the so-called "dollar-value" method of pricing inventories, or any other method of computation established to the satisfaction of the Commissioner as reasonably adaptable to the purpose and intent of section 472 and this section, and if such taxpayer elects under section 472 to use the LIFO inventory method authorized by such section, the taxpayer's opening and closing inventories shall be determined under section 472 by the use of the appropriate adaptation. See § 1.472-8 for rules relating to the use of the dollar-value method.

PAR. 2. The introductory paragraph of § 1.472-2 is amended to read as follows:

§ 1.472-2 Requirements incident to adoption and use of LIFO inventory method.

Except as otherwise provided in § 1.472-1 with respect to raw material computations, with respect to retail inventory computations, and with respect to other methods of computation established to the satisfaction of the Commissioner as reasonably adapted to the purpose and intent of section 472, and in § 1.472-8 with respect to the "dollar-value" method, the adoption and use of the LIFO inventory method is subject to the following requirements:

PAR. 3. The following new § 1.472-8 is inserted immediately after § 1.472-7.

§ 1.472-8 Dollar-value method of pricing LIFO inventories.

(a) *Election to use dollar-value method.* Any taxpayer may elect to determine the cost of his LIFO inventories under the so-called "dollar-value" LIFO method, provided such method is used consistently and clearly reflects the income of the taxpayer in accordance with the rules of this section. The dollar-value method of valuing LIFO inventories is a method of determining cost by using "base-year" cost expressed in terms of total dollars rather than the quantity and price of specific goods as the unit of measurement. Under such method the goods contained in the inventory are grouped into a pool or pools as described in paragraphs (b) and (c) of this section. The term "base-year cost" is the aggregate of the cost (determined as of the beginning of the taxable year for which the LIFO method is first adopted, i.e., the base date) of all items in a pool. The taxable year for which the LIFO method is first adopted with respect to any item in the pool is the "base year" for that pool, except as provided in paragraph (g)(3) of this section. Liquidations and increments of items contained in the pool shall be reflected only in terms of a net liquidation or increment for the pool as a whole. Fluctuations may occur in quantities of various items within the pool, new items which properly fall within the pool may be added, and old items may disappear from the pool, all without necessarily effecting a change in the dollar value of the pool as a whole. An increment in the LIFO inventory occurs when the end of the year inventory for any pool expressed in terms of base-year cost is in excess of the beginning of the year inventory for that pool expressed in terms of base-year cost. In determining the inventory value for a pool, the increment, if any, is adjusted for changing unit costs or values by reference to a percentage, relative to base-year-cost, determined for the pool as a whole. See paragraph (e) of this section. See also paragraph (f) of this section for rules relating to the change to the dollar-value LIFO method from another LIFO method.

(b) *Principles for establishing pools of manufacturers and processors*—(1) *Natural business unit pools.* A pool shall consist of all items entering into the entire inventory investment for a natural business unit of a business enterprise, unless the taxpayer elects to use the multiple pooling method provided in subparagraph (3) of this paragraph. Thus, if a business enterprise is composed of only one natural business unit, one pool shall be used for all of its inventories, including raw materials, goods in process, and finished goods. If, however, a business enterprise is actually composed of more than one natural business unit, more than one pool is required. Where similar types of goods are inventoried in two or more natural business units of the taxpayer, the Commissioner may apportion or allocate such goods among the various natural business units, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of such taxpayer. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, any pooling of the LIFO inventory of such purchased goods for the wholesaling or retailing operations shall be determined in accordance with the rules of paragraph (c) of this section.

(2) *Definition of natural business unit.* (i) Whether an enterprise is composed of more than one natural business unit is a matter of fact to be determined from all the circumstances. The natural business divisions adopted by the taxpayer for internal management purposes, the existence of separate and distinct production facilities and processes, and the maintenance of separate profit and loss records with respect to separate operations are important considerations in determining what is a business unit, unless such divisions, facilities, or accounting records are set up merely because of differences in geographical location. In the case of a manufacturer or processor, a natural business unit ordinarily con-

sists of the entire productive activity of the enterprise within one product line or within two or more related product lines including (to the extent engaged in by the enterprise) the obtaining of materials, the processing of materials, and the selling of manufactured or processed goods. Thus, in the case of a manufacturer or processor, the maintenance and operation of a raw material warehouse does not generally constitute, of itself, a natural business unit. If the taxpayer maintains and operates a supplier unit the production of which is both sold to others and transferred to a different unit of the taxpayer to be used as a component part of another product, the supplier unit will ordinarily constitute a separate and distinct natural business unit. Ordinarily, a processing plant would not in itself be considered a natural business unit if the production of the plant, although saleable at this stage, is not sold to others, but is transferred to another plant of the enterprise, not operated as a separate division, for further processing or incorporation into another product. On the other hand, if the production of a manufacturing or processing plant is transferred to a separate and distinct division of the taxpayer, which constitutes a natural business unit, the supplier unit itself will ordinarily be considered a natural business unit. However, the mere fact that a portion of the production of a manufacturing or processing plant may be sold to others at a certain stage of processing with the remainder of the production being further processed or incorporated into another product will not of itself be determinative that the activities devoted to the production of the portion sold constitute a separate business unit. Where a manufacturer or processor is also engaged in the wholesaling or retailing of goods purchased from others, the wholesaling or retailing operations with respect to such purchased goods shall not be considered a part of any manufacturing or processing unit.

(ii) The rules of this subparagraph may be illustrated by the following examples:

Example (1). A corporation manufactures, in one division, automatic clothes washers and driers of both commercial and domestic grade as well as electric ranges, mangles, and dishwashers. The corporation manufactures, in another division, radios and television sets. The manufacturing facilities and processes used in manufacturing the radios and television sets are distinct from those used in manufacturing the automatic clothes washers, etc. Under these circumstances, the enterprise would consist of two business units and two pools would be appropriate, one consisting of all of the LIFO inventories entering into the manufacture of clothes washers and driers, electric ranges, mangles, and dishwashers and the other consisting of all of the LIFO inventories entering into the production of radio and television sets.

Example (2). A taxpayer produces plastics in one of its plants. Substantial amounts of the production are sold as plastics. The remainder of the production is shipped to a second plant of the taxpayer for the production of plastic toys which are sold to customers. The taxpayer operates his plastics plant and toy plant as separate divisions. Because of the different product lines and the separate divisions the taxpayer has two natural business units.

Example (3). A taxpayer is engaged in the manufacture of paper. At one stage of processing, uncoated paper is produced. Substantial amounts of uncoated paper are sold at this stage of processing. The remainder of the uncoated paper is transferred to the taxpayer's finishing mill where coated paper is produced and sold. This taxpayer has only one natural business unit since coated and uncoated paper are within the same product line.

(3) *Multiple pools*—(i) *Principles for establishing multiple pools.* (*a*) A taxpayer may elect to establish multiple pools for inventory items which are not within a natural business unit as to which the taxpayer has adopted the natural business unit method of pooling as provided in subparagraph (1) of this paragraph. Each such pool shall ordinarily consist of a group of inventory items which are substantially similar. In determining whether such similarity exists, consideration shall be given to all the facts and circumstances. The formulation of detailed rules for selection of pools applicable to all taxpayers is not feasible. Important considerations to be taken into account include, for example, whether there is substantial similarity in the types of raw materials used or in the processing operations applied; whether the raw materials used are readily interchangeable; whether there is similarity in the use of the products; whether the groupings are consistently followed for purposes of internal accounting and management; and whether the groupings follow customary business practice in the taxpayer's industry. The selection of pools in each case must also take into consideration such factors as the nature of the inventory items subject to the dollar-value LIFO method and the significance of such items to the taxpayer's business operations. Where similar types of goods are inventoried in natural business units and multiple pools of the taxpayer, the Commissioner may apportion or allocate such goods among the natural business units and the multiple pools, if he determines that such apportionment or allocation is necessary in order to clearly reflect the income of the taxpayer.

(*b*) Raw materials which are substantially similar shall be pooled together in accordance with the principles of this subparagraph. However, inventories of raw or unprocessed materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(*c*) Finished goods and goods-in-process in the inventory shall be placed into pools classified by major classes or types of goods. The same class or type of finished goods and goods-in-process shall ordinarily be included in the same pool. Where the material content of a class of finished goods and goods-in-process included in a pool has been changed, for example, to conform with current trends in an industry, a separate pool of finished goods and goods-in-process will not ordinarily be required unless the change in material content results in a substantial change in the finished goods.

(*d*) The requirement that pools be established by major types of materials or major classes of goods is not to be construed so as to preclude the establishment of a miscellaneous pool. Since a taxpayer may elect the dollar-value LIFO method with respect to all or any designated goods in his inventory, there may be a number of such inventory items covered in the election. A miscellaneous pool shall consist only of items which are relatively insignificant in dollar value by comparison with other inventory items in the particular trade or business and which are not properly includible as part of another pool.

(ii) *Raw materials content pools.* The dollar-value method of pricing LIFO inventories may be used in conjunction with the raw materials content method authorized in § 1.472–1. Raw materials (including the raw material content of finished goods and goods-in-process) which are substantially similar shall be pooled together in accordance with the principles of subdivision (i) of this subparagraph. However, inventories of materials of an unlike nature may not be placed into one pool, even though such materials become part of otherwise identical finished products.

(c) *Principles for establishing pools for wholesalers, retailers, etc.* Items of inventory in the hands of wholesalers, retailers, jobbers, and distributors shall be placed into pools by major lines, types, or classes of goods. In determining such groupings, customary business classifications of the particular trade in which the taxpayer is engaged is an important consideration. An example of such customary business classification is the department in the department store. In such case, practices are relatively uniform throughout the trade, and departmental grouping is peculiarly adapted to the customs and needs of the business. However, in appropriate cases, the principles set forth in paragraphs (b) (1) and (2) of this section, relating to pooling by natural business units, may be used, with permission of the Commissioner, by wholesalers, retailers, jobbers, or distributors. Where a wholesaler or retailer is also engaged in the manufacturing or processing of goods, the pooling of the LIFO inventory for the manufacturing or processing operations shall be determined in accordance with the rules of paragraph (b) of this section.

(d) *Determination of appropriateness of pools.* Whether the number and the composition of the pools used by the taxpayer is appropriate, as well as the propriety of all computations incidental to the use of such pools, will be determined in connection with the examination of the taxpayer's income tax returns. Adequate records must be maintained to support the base-year unit cost as well as the current-year unit cost for all items priced on the dollar-value LIFO inventory method, regardless of the method authorized by paragraph (e) of this section which is used in computing the LIFO value of the dollar-value pool. The pool or pools selected must be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless per-

mission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446–1. However, see paragraph (h) of this section for authorization to change the method of pooling in certain specified cases.

(e) *Methods of computation of the LIFO value of a dollar-value pool*—(1) *Methods authorized.* A taxpayer may ordinarily use only the so-called "double-extension" method for computing the base-year and current-year cost of a dollar-value inventory pool. Where the use of the double-extension method is impractical, because of technological changes, the extensive variety of items, or extreme fluctuations in the variety of the items, in a dollar-value pool, the taxpayer may use an index method for computing all or part of the LIFO value of the pool. An index may be computed by double-extending a representative portion of the inventory in a pool or by the use of other sound and consistent statistical methods. The index used must be appropriate to the inventory pool to which it is to be applied. The appropriateness of the method of computing the index and the accuracy, reliability, and suitability of the use of such index must be demonstrated to the satisfaction of the district director in connection with the examination of the taxpayer's income tax returns. The use of any so-called "link-chain" method will be approved for taxable years beginning after December 31, 1960, only in those cases where the taxpayer can demonstrate to the satisfaction of the district director that the use of either an index method or the double-extension method would be impractical or unsuitable in view of the nature of the pool. A taxpayer using either an index or link-chain method shall attach to his income tax return for the first taxable year beginning after December 31, 1960, for which the index or link-chain method is used, a statement describing the particular link-chain method or the method used in computing the index. The statement shall be in sufficient detail to facilitate the determination as to whether the method used meets the standards set forth in this subparagraph. In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D.C. The taxpayer shall submit such other information as may be requested with respect to such index or link-chain method. Adequate records must be maintained by the taxpayer to support the appropriateness, accuracy, and reliability of an index or link-chain method. A taxpayer may request the Commissioner to approve the appropriateness of an index or link-chain method for the first taxable year beginning after December 31, 1960, for which it is used. Such request must be submitted within 90 days after the beginning of the first taxable year beginning after December 31, 1960, in which the taxpayer desires to use the index or link-chain method, or on or before May 1, 1961, whichever is later. A taxpayer entitled to use the retail method of pricing LIFO inventories authorized by § 1.472–1(k) may use retail price indexes prepared by the United States Bureau of Labor Statistics. Any method of computing the LIFO value of a dollar-value pool must be used for the year of adoption and all subsequent taxable years, unless the taxpayer obtains the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1 to use a different method.

(2) *Double extension method.* (i) Under the double-extension method the quantity of each item in the inventory pool at the close of the taxable year is extended at both base-year unit cost and current-year unit cost. The respective extensions at the two costs are then each totaled. The first total gives the amount of the current inventory in terms of base-year cost and the second total gives the amount of such inventory in terms of current-year cost.

(ii) The total current-year cost of items making up a pool may be determined—

(*a*) By reference to the actual cost of the goods most recently purchased or produced;

(*b*) By reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition;

(*c*) By application of an average unit cost equal to the aggregate cost of all of the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced; or

(*d*) Pursuant to any other proper method which, in the opinion of the Commissioner, clearly reflects income.

(iii) Under the double-extension method a base-year unit cost must be ascertained for each item entering a pool for the first time subsequent to the beginning of the base year. In such a case, the base-year unit cost of the entering item shall be the current-year cost of that item unless the taxpayer is able to reconstruct or otherwise establish a different cost. If the entering item is a product or raw material not in existence on the base date, its cost may be reconstructed, that is, the taxpayer using reasonable means may determine what the cost of the item would have been had it been in existence in the base year. If the item was in existence on the base date but not stocked by the taxpayer, he may establish, by using available data or records, what the cost of the item would have been to the taxpayer had he stocked the item. If the base-year unit cost of the entering item is either reconstructed or otherwise established to the satisfaction of the Commissioner, such cost may be used as the base-year unit cost in applying the double-extension method. If the taxpayer does not reconstruct or establish to the satisfaction of the Commissioner a base-year unit cost, but does reconstruct or establish to the satisfaction of the Commissioner the cost of the item at some year subsequent to the base year, he may use the earliest cost which he does reconstruct or establish as the base-year unit cost.

(iv) To determine whether there is an increment or liquidation in a pool for a particular taxable year, the end of the year inventory of the pool expressed in terms of base-year cost is compared with the beginning of the year inventory of the pool expressed in terms of base-year cost. When the end of the year inventory of the pool is in excess of the beginning of the year inventory of the pool, an increment occurs in the pool for that year. If there is an increment for the taxable year, the ratio of the total current-year cost of the pool to the total base-year cost of the pool must be computed. This ratio when multiplied by the amount of the increment measured in terms of base-year cost gives the LIFO value of such increment. The LIFO value of each such increment is hereinafter referred to in this section as the "layer of increment" and must be separately accounted for and a record thereof maintained as a separate layer of the pool, and may not be combined with a layer of increment occurring in a different year. On the other hand, when the end of the year inventory of the pool is less than the beginning of the year inventory of the pool, a liquidation occurs in the pool for that year. Such liquidation is to be reflected by reducing the most recent layer of increment by the excess of the beginning of the year inventory over the end of the year inventory of the pool. However, if the amount of the liquidation exceeds the amount of the most recent layer of increment, the preceding layers of increment in reverse chronological order are to be successively reduced by the amount of such excess until all the excess is absorbed. The base-year inventory is to be reduced by liquidation only to the extent that the aggregate of all liquidation exceeds the aggregate of all layers of increment.

(v) The following examples illustrate the computation of the LIFO value of inventories under the double-extension method.

Example (1). (*a*) A taxpayer elects, beginning with the calendar year 1961, to compute his inventories by use of the LIFO inventory method under section 472 and further elects to use the dollar-value method in pricing such inventories as provided in paragraph (a) of this section. He creates Pool No. 1 for items A, B, and C. The composition of the inventory for Pool No. 1 at the base date, January 1, 1961, is as follows:

Items	Units	Unit cost	Total cost
A	1,000	$5	$5,000
B	2,000	4	8,000
C	500	2	1,000
Total base-year cost at Jan. 1, 1961			14,000

(*b*) The closing inventory of Pool No. 1 at December 31, 1961, contains 3,000 units of A, 1,000 units of B, and 500 units of C. The taxpayer computes the current-year cost of the items making up the pool by reference to the actual cost of goods most recently purchased. The most recent purchases of items A, B, and C are as follows:

Item	Purchase date	Quantity purchased	Unit cost
A	Dec. 15, 1961	3,500	$6.00
B	Dec. 10, 1961	2,000	5.00
C	Nov. 1, 1961	500	2.50

(c) The inventory of Pool No. 1 at December 31, 1961, shown at base-year and current-year cost is as follows:

Item	Quantity	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1961, inventory at current-year cost	
		Unit cost	Amount	Unit cost	Amount
A	3,000	$5.00	$15,000	$6.00	$18,000
B	1,000	4.00	4,000	5.00	5,000
C	500	2.00	1,000	2.50	1,250
Total			$20,000		$24,250

(d) If the amount of the December 31, 1961, inventory at base-year cost were equal to, or less than, the base-year cost of $14,000 at January 1, 1961, such amount would be the closing LIFO inventory at December 31, 1961. However, since the base-year cost of the closing LIFO inventory at December 31, 1961, amounts to $20,000, and is in excess of the $14,000 base-year cost of the opening inventory for that year, there is a $6,000 increment in Pool No. 1 during the year. This increment must be valued at current-year cost, i.e., the ratio of $24,250/20,000, or 121.25 percent. The LIFO value of the inventory at December 31, 1961, is $21,275, computed as follows:

Pool No. 1

	Dec. 31, 1961, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1961, inventory at LIFO value
		Percent	
Jan. 1, 1961, base cost	14,000	100.00	$14,000
Dec. 31, 1961, increment	6,000	121.25	7,275
Total	20,000		21,275

Example (2). (a) Assume the taxpayer in example (1) during the year 1962 completely disposes of item C and purchases item D. Assume further that item D is properly includible in Pool No. 1 under the provisions of this section. The closing inventory on December 31, 1962, consists of quantities at current-year unit cost, as follows:

Items	Units	Current-year unit cost Dec. 31, 1962
A	2,000	$6.50
B	1,500	6.00
D	1,000	5.00

(b) The taxpayer establishes that the cost of item D, had he acquired it on January 1, 1961, would have been $2.00 per unit. Such cost shall be used as the base-year unit cost for item D, and the LIFO computations at December 31, 1962, are made as follows:

Item	Quantity	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost		Dec. 31, 1962, inventory at current-year cost	
		Unit cost	Amount	Unit cost	Amount
A	2,000	$5.00	$10,000	$6.50	$13,000
B	1,500	4.00	6,000	6.00	9,000
D	1,000	2.00	2,000	5.00	5,000
Total			18,000		27,000

(c) Since the closing inventory at base-year cost, $18,000, is less than the 1962 opening inventory at base-year cost, $20,000, a liquidation of $2,000 has occurred during 1962. This liquidation is to be reflected by reducing the most recent layer of increment. The LIFO value of the inventory at December 31, 1962, is $18,850, and is summarized as follows:

Pool No. 1

	Dec. 31, 1962, inventory at Jan. 1, 1961, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1962, inventory at LIFO value
		Percent	
Jan. 1, 1961, base cost	14,000	100.00	$14,000
Dec. 31, 1961, increment	4,000	121.25	4,850
Total	18,000		18,850

(f) *Change to dollar-value method from another method of pricing LIFO inventories*—(1) *Consent required.* Except as provided in § 1.472–3 in the case of a taxpayer electing to use a LIFO inventory method for the first time, or in the case of a taxpayer changing to the dollar-value method and continuing to use the same pools as were used under another LIFO method, a taxpayer using another LIFO method of pricing inventories may not change to the dollar-value method of pricing such inventories unless he first secures the consent of the Commissioner in accordance with paragraph (e) of § 1.446–1.

(2) *Method of converting inventory.* Where the taxpayer changes from one method of pricing LIFO inventories to the dollar-value method, the ending LIFO inventory for the taxable year immediately preceding the year of change shall be converted to the dollar-value LIFO method. This is done to establish the base-year cost for subsequent calculations. Thus, if the taxpayer was previously valuing LIFO inventories on the specific goods method, these separate values shall be combined into appropriate pools. For this purpose, the base year for the pool shall be the earliest taxable year for which the LIFO inventory method had been adopted for any item in that pool. No change will be made in the overall LIFO value of the opening inventory for the year of change as a result of the conversion, and that inventory will merely be restated in the manner used under the dollar-value method. All layers of increment for such inventory must be retained, except that all layers of increment which occurred in the same taxable year must be combined. The following examples illustrate the provisions of this subparagraph:

Example (1). (i) Assume that the taxpayer has used another LIFO method for finished goods since 1954 and has complied with all the requirements prerequisite for a change to the dollar-value method. Items A, B, and C, which have previously been inventoried under the specific goods LIFO method, may properly be included in a single dollar-value LIFO pool. The LIFO inventory value of items A, B, and C at December 31, 1960, is $12,200, computed as follows:

Year	Base quantity and yearly increments	Unit cost	Dec. 31, 1960, inventory at LIFO value
Item A			
1954 (base year)	100	$1	$100
1955	200	2	400
1956	100	4	400
1960	100	6	600
Total	500		1,500
Item B			
1954 (base year)	300	6	1,800
1955	100	8	800
1960	50	10	500
Total	450		3,100
Item C			
1954 (base year)	1,000	4	4,000
1955	200	6	1,200
1956	300	8	2,400
Total	1,500		7,600
LIFO value of items A, B, and C at Dec. 31, 1960			12,200

There were no increments in the years 1957, 1958, or 1959.

(ii) The computation of the ratio of the total current-year cost to the total base-year cost for the base year and each layer of increment in Pool No. 1 is shown as follows:

Item	1954 base-year unit cost	Year 1954	Increments		
			1955	1956	1960
A					
Base-year cost	$1.00	$100	$200	$100	$100
LIFO value		100	400	400	600
B					
Base-year cost	6.00	1,800	600		300
LIFO value		1,800	800		500
C					
Base-year cost	4.00	4,000	800	1,200	
LIFO value		4,000	1,200	2,400	
Total—Base-year cost		5,900	1,600	1,300	400
Total—LIFO value		5,900	2,400	2,800	1,100
Ratio of total current-year cost to total base-year cost (percent)		100.00	150.00	215.38	275.00

(iii) On the basis of the foregoing computations, the LIFO inventory of Pool No. 1, at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1960, inventory at LIFO value
		Percent	
1954 base cost	5,900	100.00	$5,900
1955 increment	1,600	150.00	2,400
1956 increment	1,300	215.38	2,800
1960 increment	400	275.00	1,100
Total	9,200		12,200

Example (2). Assume the same facts as in example (1) and assume further that the base-year cost of Pool No. 1 at December 31, 1961, is $8,350. Since the closing inventory for the taxable year 1961 at base-year cost is less than the opening inventory for that

year at base-year cost, a liquidation has occurred during 1961. This liquidation absorbs all of the 1960 layer of increment and part of the 1956 layer of increment. The December 31, 1961, inventory is $10,131, computed as follows:

	Dec. 31, 1961, inventory at base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1961, inventory at LIFO value
		Percent	
1954 base cost	5,900	100.00	$5,900
1955 increment	1,600	150.00	2,400
1956 increment	850	215.38	1,831
Total	8,350		10,131

(g) *Transitional rules*—(1) *Change in method of pooling.* Any method of pooling authorized by this section and used by the taxpayer in computing his LIFO inventories under the dollar-value method shall be treated as a method of accounting. Any method of pooling which is authorized by this section shall be used for the year of adoption and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commissioner as provided in paragraph (e) of § 1.446–1. Where the taxpayer changes from one method of pooling to another method of pooling permitted by this section, the ending LIFO inventory for the taxable year preceding the year of change shall be restated under the new method of pooling.

(2) *Manner of combining or separating dollar-value pools.* (i) A taxpayer who has been using the dollar-value LIFO method and who is permitted or required to change his method of pooling, shall combine or separate the LIFO value of his inventory for the base year and each yearly layer of increment in order to conform to the new pool or pools. Each yearly layer of increment in the new pool or pools must be separately accounted for and a record thereof maintained, and any liquidation occurring in the new pool or pools subsequent to the formation thereof shall be treated in the same manner as if the new pool or pools had existed from the date the taxpayer first adopted the LIFO inventory method. The combination or separation of the LIFO value of his inventory for the base year and each yearly layer of increment shall be made in accordance with the appropriate method set forth in this subparagraph, unless the use of a different method is approved by the Commissioner.

(ii) Where the taxpayer is permitted or required to separate a pool into more than one pool, the separation shall be made in the following manner: First, each item in the former pool shall be placed in an appropriate new pool. Every item in each new pool is then extended at its base-year unit cost and the extensions are totaled. Each total is the amount of inventory for each new pool expressed in terms of base-year cost. Then a ratio of the total base-year cost of each new pool to the base-year cost of the former pool is computed. The resulting ratio is applied to the amount of inventory for the base year and each yearly layer of increment of the former pool to obtain an allocation to each new pool of the base-year inventory of the former pool and subsequent layers of increment thereof. The foregoing may be illustrated by the following example of a change for the taxable year 1961:

Example. (a) Assume that items A, B, C, and D are all grouped together in one pool prior to December 31, 1960. The LIFO inventory value at December 31, 1960, is computed as follows:

	Pool ABCD		
	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1960, inventory at LIFO value
		Percent	
Jan. 1, 1956, base cost	10,000	100	$10,000
Dec. 31, 1956, increment	1,000	110	1,100
Dec. 31, 1958, increment	5,000	120	6,000
Dec. 31, 1960, increment	4,000	125	5,000
Total	20,000		22,100

(b) The extension of the quantity of items A, B, C, and D at respective base-year unit costs is as follows:

Item	Quantity	Base-year unit cost	Amount
A	2,000	$2	$4,000
B	1,000	3	3,000
C	1,000	5	5,000
D	4,000	2	8,000
Total			20,000

(c) Under the provisions of this section the taxpayer separates former Pool ABCD into two pools, Pool AB and Pool CD. The computation of the ratio of total base-year cost for each of the new pools to the base-year cost of the former pool is as follows:

Item	Total base-year cost	Ratio
Pool AB:		
A	$4,000	
B	3,000	
	7,000	7,000/20,000
Pool CD:		
C	5,000	
D	8,000	
	13,000	13,000/20,000
Total for pool ABCD	20,000	

(d) The ratio of the base-year cost of new Pools AB and CD to the base-year cost of former Pool ABCD is 7,000/20,000 and 13,000/20,000, respectively. The allocation of the January 1, 1956 base cost and subsequent yearly layers of increment of former Pool ABCD to new Pools AB and CD is as follows:

	Base-year cost to be allocated	Pool	
		AB	CD
Jan. 1, 1956, base cost	$10,000	$3,500	$6,500
Dec. 31, 1956, increment	1,000	350	650
Dec. 31, 1958, increment	5,000	1,750	3,250
Dec. 31, 1960, increment	4,000	1,400	2,600
Total	20,000	7,000	13,000

(e) The LIFO value of new Pools AB and CD at December 31, 1960, as allocated, is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1960, inventory at LIFO value
Pool AB			
		Percent	
Jan. 1, 1956, base cost	3,500	100	$3,500
Dec. 31, 1956, increment	350	110	385
Dec. 31, 1958, increment	1,750	120	2,100
Dec. 31, 1960, increment	1,400	125	1,750
Total	7,000		7,735
Pool CD			
Jan. 1, 1956, base cost	6,500	100	6,500
Dec. 31, 1956, increment	650	110	715
Dec. 31, 1958, increment	3,250	120	3,900
Dec. 31, 1960, increment	2,600	125	3,250
Total	13,000		14,365

(iii) Where the taxpayer is permitted or required to combine two or more pools having the same base year, they shall be combined into one pool in the following manner: The LIFO value of the base-year inventory of each of the former pools is combined to obtain a LIFO value of the base-year inventory for the new pool. Then, any layers of increment in the various pools which occurred in the same taxable year are combined into one total layer of increment for that taxable year. However, layers of increment which occurred in different taxable years may not be combined. In combining the layers of increment a new ratio of current-year cost to base-year cost is computed for each of the combined layers of increment. The foregoing may be illustrated by the following example:

Example. (a) Assume the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
		Percent	
Jan. 1, 1957, base cost	10,000	100	$10,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	1,000	120	1,200
Total	13,000		13,400
Pool No. 2			
Jan. 1, 1957, base cost	5,000	100	5,000
Dec. 31, 1960, increment	3,000	140	4,200
Total	8,000		9,200

(b) The computation of the ratio of the total current-year cost to the total base-year

cost for the base year and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1957	Increments	
		Dec. 31, 1957	Dec. 31, 1960
No. 1:			
Base-year cost	$10,000	$2,000	$1,000
LIFO value	10,000	2,200	1,200
No. 2:			
Base-year cost	5,000	----------	3,000
LIFO value	5,000	----------	4,200
Total, base-year cost	15,000	2,000	4,000
Total, LIFO value	15,000	2,200	5,400
Ratio of total current-year cost to total base-year cost (percent)	100	110	135

(c) On the basis of the foregoing computations, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1957, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1960, inventory at LIFO value
		Percent	
Jan. 1, 1957, base cost	15,000	100	$15,000
Dec. 31, 1957, increment	2,000	110	2,200
Dec. 31, 1960, increment	4,000	135	5,400
Total	21,000	----------	22,600

(iv) In combining pools having different base years, the principles set forth in subdivision (iii) of this subparagraph are to be applied, except that all base years subsequent to the earliest base year shall be treated as increments, and the base-year costs for all pools having a base year subsequent to the earliest base year of any pool shall be redetermined in terms of the base cost for the earliest base year. The foregoing may be illustrated by the following example:

Example. (a) Assume that the taxpayer has two pools at December 31, 1960. Under the provisions of this section the taxpayer combines these pools into a single pool as of January 1, 1961. The LIFO inventory value of each pool at December 31, 1960, is shown as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1960, inventory at LIFO value
Pool No. 1			
		Percent	
Jan. 1, 1956, base cost	7,000	100	$7,000
Dec. 31, 1956, increment	1,000	105	1,050
Dec. 31, 1957, increment	500	110	550
Dec. 31, 1958, increment	500	110	550
Dec. 31, 1960, increment	1,000	120	1,200
Total	10,000	----------	10,350
	Dec. 31, 1960, inventory at Jan. 1, 1958, base-year cost		
Pool No. 2			
Jan. 1, 1958, base cost	3,500	100	$3,500
Dec. 31, 1958, increment	1,000	110	1,100
Dec. 31, 1959, increment	500	115	575
Total	5,000	----------	5,175

(b) The next step is to redetermine the 1958 base-year cost for Pool No. 2 in terms of 1956 base-year cost. January 1, 1956 base-year unit cost must be reconstructed or established in accordance with paragraph (e)(2) of this section for each item in Pool No. 2. Such costs are assumed to be $9.00 for item A, $20.00 for item B, and $1.80 for item C. A ratio of the 1958 total base-year cost to the 1956 total base-year cost for Pool No. 2 is computed as follows:

Item	Quantity	Jan. 1, 1956, base-year unit cost	Jan. 1, 1956, base-year cost
A	250	$9.00	$2,250
B	75	20.00	1,500
C	500	1.80	900
Total	----------	----------	4,650

Item	Quantity	Jan. 1, 1958, base-year unit cost	Jan. 1, 1958, base-year cost
A	250	$10.00	$2,500
B	75	20.00	1,500
C	500	2.00	1,000
Total	----------	----------	5,000

(c) The ratio of the 1956 total base-year cost to the 1958 total base-year cost for Pool No. 2 is 4,650/5,000 or 93 percent. The January 1, 1958 base cost and each yearly layer of increment at 1958 base-year cost is multiplied by this ratio. Such computation is as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1958, base-year cost	Ratio	Dec. 31, 1960, inventory restated at Jan. 1, 1956, base-year cost
		Percent	
Jan. 1, 1958, base cost	3,500	93	$3,255
Dec. 31, 1958, increment	1,000	93	930
Dec. 31, 1959, increment	500	93	465
Total	----------	----------	4,650

(d) The computation of the ratio of the total current-year cost to the total base-year cost for the base year (1956) and each yearly layer of increment in the new pool is as follows:

Pool	Base year 1956	Increments				
		Dec. 31, 1956	Dec. 31, 1957	Dec. 31, 1958	Dec. 31, 1959	Dec. 31, 1960
No. 1:						
Base-year cost	$7,000	$1,000	$500	$500	----------	$1,000
LIFO value	7,000	1,050	550	550	----------	1,200
No. 2:						
Base-year cost as restated	----------	----------	3,255	930	$465	----------
LIFO value	----------	----------	3,500	1,100	575	----------
Total, base-year cost	7,000	1,000	3,755	1,430	465	1,000
Total, LIFO value	7,000	1,050	4,050	1,650	575	1,200
Ratio of total current-year cost to total base-year cost (percent)	100.00	105.00	107.86	115.38	123.66	120.00

(e) On the basis of the foregoing computation, the LIFO inventory of the new pool at December 31, 1960, is restated as follows:

	Dec. 31, 1960, inventory at Jan. 1, 1956, base-year cost	Ratio of total current-year cost to total base-year cost	Dec. 31, 1960, inventory at LIFO value
		Percent	
Jan. 1, 1956, base cost	7,000	100.00	$7,000
Dec. 31, 1956, increment	1,000	105.00	1,050
Dec. 31, 1957, increment	3,755	107.86	4,050
Dec. 31, 1958, increment	1,430	115.38	1,650
Dec. 31, 1959, increment	465	123.66	575
Dec. 31, 1960, increment	1,000	120.00	1,200
Total	14,650	----------	15,525

(3) *Change in methods of computation of the LIFO value of a dollar-value pool.* For the first taxable year beginning after December 31, 1960, the taxpayer must use a method authorized by paragraph (e)(1) of this section in computing the base-year cost and current-year cost of a dollar-value inventory pool for the end of such year. If the taxpayer had previously used any methods other than one authorized by paragraph (e)(1) of this section, he shall not be required to recompute his LIFO inventories for taxable years beginning on or before December 31, 1960, under a method authorized by such paragraph. The base cost and layers of increment previously computed by such other method shall be retained and treated as if such base cost and layers of increment had been computed under a method authorized by paragraph (e)(1) of this section. The taxpayer shall use the year of change as the base year in applying the double-extension method or other method approved by the Commissioner, instead of the earliest year for which he adopted the LIFO method for any items in the pool.

(h) *Change without consent in method of pooling*—(1) *Authorization.* Notwithstanding the provisions of paragraph (g) of this section, a taxpayer, for his first taxable year ending after April 15, 1961, may change from one method of pooling authorized by this section to any other method of pooling authorized by this section provided the requirements of subparagraph (2) of this paragraph are met. Also, for such year, if a taxpayer is currently using only a method of pooling authorized by this section, or a method of pooling which would be authorized by this section if additional items were included in the pool, and could change to the natural business unit method, except for the fact he has not inventoried all items entering into the inventory investment for such natural business unit on the LIFO method, he may change to the natural business unit method if he elects under the provisions of § 1.472–3 to extend the LIFO election to all items entering into the entire inventory investment for such natural business unit, provided the requirements of subparagraph (2) of this paragraph are met. The method of pooling adopted shall be used for the

year of change and for all subsequent taxable years unless a change is required by the Commissioner in order to clearly reflect income, or unless permission to change is granted by the Commission as provided in paragraph (e) of § 1.446–1.

(2) *Requirements.* A statement shall be attached to the income tax return for the year of change referred to in subparagraph (1) of this paragraph setting forth, in summary form, the following information:

(i) A description of the new pool or pools,

(ii) The basis for selection of the new pool or pools,

(iii) A schedule showing the computation of the LIFO value of the former pool or pools, and,

(iv) A schedule showing the transition from the former pool or pools to the new pool or pools.

In addition, a copy of the statement shall be filed with the Commissioner of Internal Revenue, Attention: T:R, Washington 25, D.C. The taxpayer shall submit such other information with respect to the change in method of pooling as may be requested.

(Sec. 7805 of the Internal Revenue Code of 1954; (68A Stat. 917; 26 U.S.C. 7805))

[F.R. Doc. 61–516; Filed, Jan. 19, 1961; 8:47 a.m.]

[T.D. 6535]

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

Life Insurance Companies

On December 10, 1960, notice of proposed rule making regarding amendment of the Income Tax Regulations under sections 809, 810, 811, 812, and 815 of the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112), relating to life insurance companies, was published in the FEDERAL REGISTER (25 F.R. 12681). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the regulations as so published, subject to the changes set forth below, are hereby adopted. Section 1.809–6 of such regulations supersedes § 19.1–2 of Treasury Decision 6415 (26 CFR Part 19), approved September 10, 1959 (24 F.R. 7373). Section 1.810–4 of such regulations supersedes § 19.1–7 of Treasury Decision 6414 (26 CFR Part 19), approved September 9, 1959 (24 F.R. 7371).

PARAGRAPH 1. Section 1.809–4 is revised—

(A) By deleting the last sentence of paragraph (a)(1)(i).

(B) By inserting the phrase "or credited" after the word "returned" in the first sentence and by deleting the phrase "rebated or" in the second sentence of paragraph (a)(1)(ii).

(C) By revising the last sentence of paragraph (b).

PAR. 2. Section 1.809–5 is revised—

(A) By deleting the word "means" appearing in the last sentence of paragraph (a)(1) and by inserting in lieu thereof "includes".

(B) By revising paragraph (a)(5)(ii).

(C) By deleting the last two sentences of paragraph (a)(6)(ii) and by inserting in lieu thereof a new sentence.

(D) By deleting the last sentence of paragraph (a)(12).

(E) By deleting the word "claimed" both times it appears in the last sentence of paragraph (b) and by inserting both times in lieu thereof "allowed".

PAR. 3. Section 1.810–4 is revised—

(A) By inserting immediately after the second sentence of paragraph (b) a new sentence.

(B) By deleting the second sentence of paragraph (c) and by inserting in lieu thereof a new sentence.

PAR. 4. Section 1.811–2 is revised—

(A) By revising paragraph (c)(1)(ii).

(B) By revising paragraph (c)(4).

PAR. 5. Paragraph (b)(2)(ii) of § 1.812–5 is revised—

(A) By deleting the word *"Example."* appearing immediately following the colon and by inserting in lieu thereof *"(a) Facts."*

(B) By deleting the figure "$11,000,000" appearing in the table as taxable investment income for 1959 and inserting in lieu thereof "$9,000,000".

(C) Subdivision *"(a)"* is relettered as *"(b)"*.

(D) Subdivision *"(b)"* is relettered as *"(c)"*.

PAR. 6. Section 1.815–4 is revised—

(A) By revising paragraph (b)(2).

(B) By revising paragraph (b)(3).

PAR. 7. Section 815–6 is revised—

(A) By deleting the first sentence of paragraph (c) and by inserting in lieu thereof a new sentence.

(B) The first table in the example appearing in paragraph (f)(2) is revised by deleting the phrase "Added for year (with regard to election under sec. 815(d)(1))" and by inserting in lieu thereof "Added for year (without regard to election under sec. 815(d)(1))".

PAR. 8. Section 1.816 is revised by adding immediately after subsection (a) of section 816 and before the historical note a subsection (b).

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 16, 1961.

FRED C. SCRIBNER, Jr.,
Acting Secretary of the Treasury.

In order to provide regulations under sections 809, 810, 811, 812, and 815 of the Internal Revenue Code of 1954, as added by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 121), the Income Tax Regulations (26 CFR Part 1) are amended as follows:

There are inserted immediately after § 1.807–1 the following new sections:

§ 1.807–2 Taxable years affected.

Section 1.807–1 is applicable only to taxable years beginning after December 31, 1953, and before January 1, 1955, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, before amendments.

GAIN AND LOSS FROM OPERATIONS

§ 1.809 Statutory provisions; life insurance companies; in general.

SEC. 809. *In general*—(a) *Exclusion of share of investment yield set aside for policyholders*—(1) *Amount.* The share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For purposes of the preceding sentence, the share of any item set aside for policyholders shall be that percentage obtained by dividing the required interest by the investment yield; except that if the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(2) *Required interest.* For purposes of this part, the required interest for any taxable year is the sum of the products obtained by multiplying—

(A) Each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by

(B) The means of the amount of such reserves computed at that rate at the beginning and end of the taxable year.

(b) *Gain and loss from operations*—(1) *Gain from operations defined.* For purposes of this part, the term "gain from operations" means the amount by which the sum of the following exceeds the deductions provided by subsection (d):

(A) The life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) The sum of the items referred to in subsection (c).

(2) *Loss from operations defined.* For purposes of this part, the term "loss from operations" means the amount by which the sum of the deductions provided by subsection (d) exceeds the sum of—

(A) The life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received); and

(B) The sum of the items referred to in subsection (c).

(3) *Life insurance company's share.* For purposes of this subpart, the life insurance company's share of any item shall be that percentage which, when added to the percentage obtained under the second sentence of subsection (a) (1), equals 100 percent.

(4) *Exception.* If it is established in any case that the application of the definition of gain from operations contained in paragraph (1) results in the imposition of tax on—

(A) Any interest which under section 103 is excluded from gross income,

(B) Any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(C) Any amount of dividends received which under sections 243, 244, and 245 (as modified by subsection (d)(8)(B)) is allowable as a deduction.

adjustment shall be made to the extent necessary to prevent such imposition.

(c) *Gross amount.* For purposes of subsections (b) (1) and (2), the following items shall be taken into account:

(1) *Premiums.* The gross amount of premiums and other consideration (including advance premiums, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer) on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. Except in the case of amounts of premiums or other consideration returned to another

life insurance company in respect of reinsurance ceded, amounts returned where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management shall not be included in return premiums.

(2) *Decreases in certain reserves.* Each net decrease in reserves which is required by section 810 or 811(b)(2) to be taken into account for purposes of this paragraph.

(3) *Other amounts.* All amounts, not included in computing investment yield and not includible under paragraph (1) or (2), which under this subtitle are includible in gross income.

Except as included in computing investment yield, there shall be excluded any gain from the sale or exchange of a capital asset, and any gain considered as gain from the sale or exchange of a capital asset.

(d) *Deductions.* For purposes of subsections (b) (1) and (2), there shall be allowed the following deductions:

(1) *Death benefits, etc.* All claims and benefits accrued, and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto).

(2) *Increases in certain reserves.* The net increase in reserves which is required by section 810 to be taken into account for purposes of this paragraph.

(3) *Dividends to policyholders.* The deduction for dividends to policyholders (determined under section 811(b)).

(4) *Operations loss deduction.* The operations loss deduction (determined under section 812).

(5) *Certain nonparticipating contracts.* An amount equal to 10 percent of the increase for the taxable year in the reserves for nonparticipating contracts or (if greater) an amount equal to 3 percent of the premiums for the taxable year (excluding that portion of the premiums which is allocable to annuity features) attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more. For purposes of this paragraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (excluding that portion of the reserves which is allocable to annuity features) as relates to nonparticipating contracts (other than group contracts). For purposes of this paragraph and paragraph (6), the term "premiums" means the net amount of the premiums and other consideration taken into account under subsection (c)(1).

(6) *Group life, accident, and health insurance.* An amount equal to 2 percent of the premiums for the taxable year attributable to group life insurance contracts and group accident and health insurance contracts. The deduction under this paragraph for the taxable year and all preceding taxable years shall not exceed an amount equal to 50 percent of the premiums for the taxable year attributable to such contracts.

(7) *Assumption by another person of liabilities under insurance, etc., contracts.* The consideration (other than consideration arising out of reinsurance ceded) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto).

(8) *Tax-exempt interest, dividends, etc.*—(A) *Life insurance company's share.* Each of the following items:

(i) The life insurance company's share of interest which under section 103 is excluded from gross income,

(ii) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)) computed with respect to the life insurance company's share of such interest, and

(iii) The deductions for dividends received provided by sections 243, 244, and 245 (as modified by subparagraph (B)) computed with respect to the life insurance company's share of the dividends received.

(B) *Application of section 246(b).* In applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of subparagraph (A)(iii), the limit on the aggregate amount of the deductions allowed by sections 243(a), 244, and 245 shall be 85 percent of the gain from operations computed without regard to—

(i) The deductions provided by paragraphs (3), (5), and (6) of this subsection,

(ii) The operations loss deduction provided by section 812, and

(iii) The deductions allowed by sections 243(a), 244, and 245,

but such limit shall not apply for any taxable year for which there is a loss from operations.

(9) *Investment expenses, etc.* Investment expenses to the extent not allowed as a deduction under section 804(c)(1) in computing investment yield, and the amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income.

(10) *Small business deduction.* A small business deduction in an amount equal to the amount determined under section 804(a)(4).

(11) *Certain mutualization distributions.* The amount of distributions to shareholders made in 1958 and 1959 in acquisition of stock pursuant to a plan of mutualization adopted before January 1, 1958.

(12) *Other deductions.* Subject to the modifications provided by subsection (e), all other deductions allowed under this subtitle for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

Except as provided in paragraph (3), no amount shall be allowed as a deduction under this subsection in respect of dividends to policyholders.

(e) *Modifications.* The modifications referred to in subsection (d)(12) are as follows:

(1) *Interest.* In applying section 163 (relating to deduction for interest), no deduction shall be allowed for interest in respect of items described in section 810(c).

(2) *Bad debts.* Section 166(c) (relating to reserve for bad debts) shall not apply.

(3) *Charitable, etc., contributions and gifts.* In applying section 170—

(A) The limit on the total deductions under such section provided by the first sentence of section 170(b)(2) shall be 5 percent of the gain from operations computed without regard to—

(i) The deduction provided by section 170,

(ii) The deductions provided by paragraphs (3), (5), (6), and (8) of subsection (d), and

(iii) Any operations loss carryback to the taxable year under section 812; and

(B) Under regulations prescribed by the Secretary or his delegate, a rule similar to the rule contained in section 170(b)(3) shall be applied.

(4) *Amortizable bond premium.* Section 171 shall not apply.

(5) *Net operating loss deduction.* The deduction for net operating losses provided in section 172 shall not be allowed.

(6) *Partially tax-exempt interest.* The deduction for partially tax-exempt interest provided by section 242 shall not be allowed.

(7) *Dividends received.* The deductions for dividends received provided by sections 243, 244, and 245 shall not be allowed.

(f) *Limitation on certain deductions*—(1) *In general.* The amount of the deductions under paragraphs (3), (5), and (6) of subsection (d) shall not exceed $250,000 plus the amount (if any) by which—

(A) The gain from operations for the taxable year, computed without regard to such deductions, exceeds

(B) The taxable investment income for the taxable year.

(2) *Application of limitation.* The limitation provided by paragraph (1) shall apply first to the amount of the deduction under subsection (d)(6), then to the amount of the deduction under subsection (d)(5), and finally to the amount of the deduction under subsection (d)(3).

(g) *Limitations on deduction for certain mutualization distributions*—(1) *Deduction not to reduce taxable investment income.* The amount of the deduction under subsection (d)(11) shall not exceed the amount (if any) by which—

(A) The gain from operations for the taxable year, computed without regard to such deduction (but after the application of subsection (f)), exceeds

(B) The taxable investment income for the taxable year.

(2) *Deduction not to reduce tax below 1957 law.* The deduction under subsection (d)(11) for the taxable year shall be allowed only to the extent that such deduction (after the application of all other deductions provided by subsection (d)) does not reduce the amount of the tax imposed by section 802(a)(1) for such taxable year below the amount of tax which would have been imposed by section 802(a) as in effect for 1957, if this part, as in effect for 1957, applied for such taxable year

(3) *Application of section 815.* That portion of any distribution with respect to which a deduction is allowed under subsection (d)(11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distribution made in 1959, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(e)(2)(B).

[Sec. 809 as added by sec. 2, Life Insurance Company Income Tax Act 1959 (73 Stat. 121)]

§ 1.809–1 Taxable years affected.

Sections 1.809–2 through 1.809–8 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

§ 1.809–2 Exclusion of share of investment yield set aside for policyholders.

(a) *In general.* Section 809 provides the rules for determining the gain or loss from operations of a life insurance company, which amount is necessary to determine life insurance company taxable income. In order to determine gain or loss from operations, a life insurance company must first determine the share of each and every item of its investment yield (as defined in section 804(c) and paragraph (a) of § 1.804–4) set aside for policyholders (as computed under section 809(a)(1) and paragraph (b) of this section), as this share is excluded from gain or loss from operations (as defined in section 809(b) (1) and (2) and paragraphs (a) and (b) of § 1.809–3, respectively). The life insurance company shall then add its share of each and every item of its investment yield to the sum of the items comprising gross amount (as described in section 809(c)

and paragraph (a) of § 1.809–4). From this sum there shall then be subtracted the deductions provided in section 809(d) and paragraph (a) of § 1.809–5. The amount thus obtained is the gain or loss from operations for the taxable year.

(b) *Computation of share of investment yield set aside for policyholders.* Section 809(a)(1) provides that the share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) of any life insurance company set aside for policyholders shall not be included in gain or loss from operations. For this purpose, the percentage used in determining the share of each of these items comprising the investment yield set aside for policyholders shall be determined by dividing the required interest (as defined in section 809(a)(2) and paragraph (d) of this section) by the investment yield (as defined in section 804(c) and paragraph (a) of § 1.804–4). The percentage thus obtained is then applied to each and every item of the investment yield so that the share of each and every item of investment yield set aside for policyholders shall be excluded from gain or loss from operations. However, if in any case the required interest exceeds the investment yield, then the share of any item set aside for policyholders shall be 100 percent.

(c) *Computation of life insurance company's share of investment yield.* For purposes of subpart C, part I, subchapter L, chapter 1 of the Code, section 809(b)(3) provides that the percentage used in determining the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be obtained by subtracting the percentage obtained under paragraph (b) of this section from 100 percent. For example, if the policyholders' percentage (as determined under section 809(a)(1) and paragraph (b) of this section) is 72.38 percent, then the life insurance company's share is 27.62 percent (100 percent minus 72.38 percent). In such a case, if the amount of a particular item is $200, then the life insurance company's share of such item included in determining gain or loss from operations is $55.24 ($200 multiplied by 27.62 percent) and the share of such item set aside for policyholders (which is excluded from gain or loss from operations) is $144.76 ($200 multiplied by 72.38 percent). For purposes of determining gain or loss from operations, the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) shall be added to the sum of the items comprising gross amount (as described in section 809(c) and paragraph (a) of § 1.809–4).

(d) *Required interest defined.* (1) For purposes of part I, section 809(a)(2) defines the term "required interest" for any taxable year as the sum of the products obtained by multiplying (i) each rate of interest required, or assumed by the taxpayer, in calculating the reserves described in section 810(c), by (ii) the means of the amount of such reserves computed at that rate at the beginning and end of the taxable year. In the case of the reserves described in section 810(c)(1), such rate of interest shall be the same as that used by the taxpayer for purposes of paragraph (b) of § 1.801–5 (relating to the definition of reserves required by law) with respect to such reserves. In the case of the reserves described in section 810(c)(2) through (5), such rate of interest shall be the same as that actually paid, credited, or accrued by the taxpayer with respect to such reserves. Thus, the required interest for any taxable year includes the elements of interest paid (as defined in section 805(e)) with respect to the reserves described in section 810(c).

(2) For purposes of computing required interest under section 809(a)(2) and subparagraph (1) of this paragraph, the amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets) before applying the rate of interest required, or assumed by the taxpayer, thereto. However, in the case of the adjustments required by section 810(d) as a result of a change in the basis of computing reserves, the adjustments to any of the reserves described in section 810(c) shall be taken into account in accordance with the rules prescribed in section 810(d) and § 1.810–3.

§ 1.809–3 Gain and loss from operations defined.

(a) *Gain from operations.* For purposes of part I, subchapter L, chapter 1 of the Code, section 809(b)(1) defines the term "gain from operations" as the excess of the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), and (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of § 1.809–4, over the sum of the deductions provided by section 809(d) and § 1.809–5.

(b) *Loss from operations.* For purposes of part I, section 809(b)(2) defines the term "loss from operations" as the excess of the sum of the deductions provided by section 809(d) and § 1.809–5 over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received), and (2) the items of gross amount taken into account under section 809(c) and paragraph (a) of § 1.809–4.

(c) *Illustration of principles.* The provisions of section 809(b)(1) through (3) and paragraphs (a) and (b) of this section may be illustrated by the following example:

Example. For the taxable year 1958, T, a life insurance company, had investment yield of $900,000, including $150,000 of dividends received from domestic corporations subject to taxation under chapter 1 of the Code, $10,000 of wholly tax-exempt interest, and $78,000 of partially tax-exempt interest. T also had items of gross amount under section 809(c) in the amount of $12,000,000 and deductions under section 809(d) of $6,963,500 (exclusive of any deductions for wholly tax-exempt interest, partially tax-exempt interest, and dividends received). For such taxable year, the share of each and every item of investment yield set aside for policyholders was 80 percent and the company's share of each and every item of investment yield was 20 percent. Based upon these figures, T had a gain from operations of $5,180,000 for the taxable year 1958, computed as follows:

	Col. 1	Col. 2 (80% x Col. 1) exclusion of policyholder's share	Col. 3 (20% x Col. 1) company's share
Interest wholly tax-exempt	$10,000	$8,000	$2,000
Interest partially tax-exempt	78,000	62,400	15,600
Dividends received	150,000	120,000	30,000
Other items of investment yield	662,000	529,600	132,400
Investment yield	900,000	720,000	180,000

Gross amount (sum of items under sec. 809(c))		12,000,000
Total		12,180,000
Less:		
Deductions under sec. 809(d)(8):		
Company's share of interest wholly tax-exempt	$2,000	
30/52 of company's share of interest partially tax-exempt (30/52 × $15,600)	9,000	
85% of company's share of dividends received (but not to exceed 85% of gain from operations as computed under sec. 809(d)(8)(B)) (85% × $30,000)	25,500	
All other deductions under sec. 809(d)	6,963,500	
		7,000,000
Gain from operations		5,180,000

(d) *Exception.* (1) In accordance with section 809(b)(4), if it is established in any case to the satisfaction of the Commissioner, or by a determination of The Tax Court of the United States, or of any other court of competent jurisdiction, which has become final, that the application of the definition of gain from operations contained in section 809(b)(1) results in the imposition of tax on—

(i) Any interest which under section 103 is excluded from gross income,

(ii) Any amount of interest which under section 242 (as modified by section 804(a)(3)) is allowable as a deduction, or

(iii) Any amount of dividends received which under sections 243, 244, and 245 (as modified by section 809(d)(8)(B)) is allowable as a deduction,

adjustment shall be made to the extent necessary to prevent such imposition.

(2) For the date upon which a decision by the Tax Court becomes final, see section 7481. For the date upon which a judgment of any other court becomes final, see paragraph (c) of § 1.1313(a)–1.

§ 1.809–4 Gross amount.

(a) *Items taken into account.* For purposes of determining gain or loss from operations under section 809(b) (1) and (2), respectively, section 809(c) specifies three categories of items which shall be taken into account. Such items are in addition to the life insurance company's share of the investment yield (as determined under section 809(a) (1) and paragraph (c) of § 1.809–2). The three categories of items taken into account are:

(1) *Premiums.* (i) The gross amount of all premiums and other consideration on insurance and annuity contracts (including contracts supplementary thereto); less return premiums, and premiums and other consideration arising out of reinsurance ceded. The term "gross amount of all premiums" means the premiums and other consideration provided in the insurance or annuity contract. Thus, the amount to be taken into account shall be the total of the premiums and other consideration without any deduction for commissions, return premiums, reinsurance, dividends to policyholders, dividends left on deposit with the company, interest applied in reduction of premiums, or any other item of similar nature. Such term includes advance premiums, premiums deferred and uncollected and premiums due and unpaid, deposits, fees, assessments, and consideration in respect of assuming liabilities under contracts not issued by the taxpayer (such as a payment or transfer of property in an assumption reinsurance transaction as defined in paragraph (a) (7) (ii) of § 1.809–5).

(ii) The term "return premiums" means amounts returned or credited which are fixed by contract and do not depend on the experience of the company or the discretion of the management. Thus, such term includes amounts refunded due to policy cancellations or erroneously computed premiums. Furthermore, amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums. For the treatment of amounts which do not meet the requirements of return premiums, see section 811 (relating to dividends to policyholders).

(iii) For purposes of section 809(c) (1) and this subparagraph, the term "reinsurance ceded" means an arrangement whereby the taxpayer (the reinsured) remains solely liable to the policyholder, whether all or only a portion of the risk has been transferred to the reinsurer. Such term includes indemnity reinsurance transactions but does not include assumption reinsurance transactions. See paragraph (a) (7) (ii) of § 1.809–5 for the definition of assumption reinsurance.

(2) *Decreases in certain reserves.* Each net decrease in reserves which is required by section 810 (a) and (d) (1) or 811(b) (2) to be taken into account for the taxable year as a net decrease for purposes of section 809(c) (2).

(3) *Other amounts.* All amounts, not included in computing investment yield and not otherwise taken into account under section 809(c) (1) or (2), shall be taken into account under section 809(c) (3) to the extent that such amounts are includible in gross income under subtitle A of the Code. See section 61 (relating to gross income defined) and the regulations thereunder.

(b) *Exclusion of net long-term capital gains.* Any net long-term capital gains (as defined in section 1222(7)) from the sale or exchange of a capital asset (or any gain considered to be from the sale or exchange of a capital asset under applicable law) shall be excluded from the determination of gain or loss from operations of a life insurance company. However, any excess of net short-term capital gain (as defined in section 1222(5)) over net long-term capital loss (as defined in section 1222(8)) is included in computing investment yield (as defined in section 804(c)) and, to that extent, is taken into account in determining gain or loss from operations under section 809.

§ 1.809–5 Deductions.

(a) *Deductions allowed.* Section 809(d) provides the following deductions for purposes of determining gain or loss from operations under section 809(b) (1) and (2), respectively:

(1) *Death benefits, etc.* All claims and benefits accrued (less reinsurance recoverable), and all losses incurred (whether or not ascertained), during the taxable year on insurance and annuity contracts (including contracts supplementary thereto). The term "all claims and benefits accrued" includes, for example, matured endowments and amounts allowed on surrender. The term "losses incurred (whether or not ascertained)" includes a reasonable estimate of the amount of the losses (based upon the facts in each case and the company's experience with similar cases) incurred but not reported by the end of the taxable year as well as losses reported but where the amount thereof cannot be ascertained by the end of the taxable year.

(2) *Increases in certain reserves.* The net increase in reserves which is required by section 810(b) and (d) (1) to be taken into account for the taxable year as a net increase for purposes of section 809(d) (2).

(3) *Dividends to policyholders.* The deduction for dividends to policyholders as determined under section 811(b) and § 1.811–2. Except as provided in section 809(d) (3) and this subparagraph, no amount shall be allowed as a deduction in respect of dividends to policyholders under section 809(d). See section 809(f) and § 1.809–7 for limitation of such deduction.

(4) *Operations loss deduction.* The operations loss deduction as determined under section 812.

(5) *Certain nonparticipating contracts.* (i) An amount equal to the greater of:

(*a*) 10 percent of the increase for the taxable year in certain life insurance reserves for nonparticipating contracts (other than group contracts); or

(*b*) 3 percent of the premiums for the taxable year attributable to nonparticipating contracts (other than group contracts) which are issued or renewed for periods of 5 years or more.

(ii) For purposes of section 809(d) (5) and this subparagraph, the term "nonparticipating contracts" means those contracts which during the taxable year contain no right to participate in the divisible surplus of the company. For example, if at any time during the taxable year for which the deduction allowed under section 809(d) (5) and this subparagraph is claimed such contracts have rights to dividends or similar distributions (as defined in section 811(a) and paragraph (a) of § 1.811–2), such contracts shall no longer be deemed nonparticipating contracts and, therefore, no deduction shall be allowed. Thus, if a class of contracts having no right to participate in the divisible surplus of the company is in force for nine years and on March 10, 1958, it is announced that such contracts shall be accorded dividend rights as of August 1, 1958, no deduction shall be allowed under section 809(d) (5) and this subparagraph for the taxable year 1958 or any succeeding taxable year, whether or not dividends are actually paid on such contracts. However, if the announcement of March 10, 1958, states that such contracts shall be accorded dividend rights as of January 1, 1959, a deduction under section 809(d) (5) and this subparagraph shall be allowed for the taxable year 1958 but not for any succeeding taxable year.

(iii) For purposes of section 809(d) (5) and this subparagraph, the term "reserves for nonparticipating contracts" means such part of the life insurance reserves (as defined in section 801(b) and § 1.801–4), other than that portion of such reserves which is allocable to annuity features, as relates to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph). The amount of life insurance reserves taken into account shall be adjusted first as required by section 818(c) (relating to an election with respect to life insurance reserves computed on a preliminary term basis) and then as required by section 806(a) (relating to adjustments for certain changes in reserves and assets). In the case of the adjustments required by section 810(d) (relating to adjustment for change in computing reserves), the increase in life insurance reserves attributable to reserve strengthening shall be taken into account in accordance with

the rules prescribed in section 810(d) and § 1.810–3.

(iv) For purposes of section 809(d)(5) and this subparagraph, the term "premiums" means the net amount of the premiums and other consideration attributable to nonparticipating contracts (as defined in subdivision (ii) of this subparagraph) which are taken into account under section 809(c)(1). For this purpose, premiums include only such amounts attributable to such contracts which are issued or renewed for periods of 5 years or more, but does not include that portion of the premiums which is allocable to annuity features. No portion of a premium shall be deemed allocable to annuity features solely because a contract, such as an endowment contract, provides that at maturity the insured shall have an option to take an annuity. The determination of whether a contract meets the 5-year requirement shall be made as of the date the contract is issued, or as of the date it is renewed, whichever is applicable. Thus, a 20-year nonparticipating endowment policy shall qualify for the deduction under section 809(d)(5), even though the insured subsequently dies at the end of the second year, since the policy is issued for a period of 5 years or more. However, a 1-year renewable term contract shall not qualify, since as of the date it is issued (or of any renewal date) it is not issued (or renewed) for a period of 5 years or more. In like manner, a policy originally issued for a 3-year period and subsequently renewed for an additional 3-year period shall not qualify. However, if this policy is renewed for a period of 5 years or more, the policy shall qualify for the deduction under section 809(d)(5) from the date it is renewed.

(v) The provisions of section 809(d)(5) and this subparagraph may be illustrated by the following example:

Example. Assume the following facts with respect to X, a life insurance company, for the taxable year 1958:

Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1–1–58	$150,000
Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12–31–58	225,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 1–1–58	48,000
Annuity reserves on nonparticipating contracts (other than group contracts) at 12–31–58	57,000
Premiums on nonparticipating contracts without annuity features (other than group contracts) issued or renewed for 5 years or more	85,000
Premiums on nonparticipating contracts allocable to annuity features (other than group contracts) issued or renewed for 5 years or more	14,000
Return premiums on nonparticipating contracts without annuity features (other than group contracts)	5,000

In order to determine the deduction under section 809(d)(5) (without regard to the limitation of section 809(f)), X would make up the following schedule:

(1) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 12–31–58	$225,000	
(2) Life insurance reserves on nonparticipating contracts without annuity features (other than group contracts) at 1–1–58	$150,000	
(3) Excess of item (1) over item (2) ($225,000 minus $150,000)	75,000	
(4) 10 percent of item (3) (10% × $75,000)		$7,500
(5) Net premiums on nonparticipating contracts without annuity features issued or renewed for 5 years or more (other than group contracts) (gross premiums on such contracts ($85,000) minus return premiums ($5,000) on such contracts)	80,000	
(6) 3 percent of item (5) (3% × $80,000)		2,400
(7) The greater of item (4) or item (6)		7,500
(8) Tentative deduction under sec. 809(d)(5) (computed without regard to the limitation of sec. 809(f))		7,500

(vi) See section 809(f) and § 1.809–7 for limitation of the deduction provided by this subparagraph.

(6) *Group life, accident, and health insurance.* (i) An amount equal to two percent of the premiums for the taxable year attributable to group life insurance contracts, group accident and health insurance contracts, or group accident and health insurance contracts with a life feature. For purposes of section 809(d)(6) and this subparagraph, the term "premiums" means the net amount of the premiums and other consideration attributable to such contracts taken into account under section 809(c)(1). The deduction allowed by section 809(d)(6) and this subparagraph for the taxable year and all preceding taxable years shall not exceed 50 percent of the net amount of the premiums attributable to such contracts for the taxable year. For example, assume that premiums attributable to group life insurance and group accident and health insurance contracts are $103,000 for the taxable year. Assume further that there are $3,000 of return premiums attributable to such contracts for the taxable year. Under the provisions of section 809(d)(6) and this subparagraph, a deduction (determined without regard to section 809(f)) of $2,000 (2 percent of $100,000 ($103,000 minus $3,000)) is allowed. Assuming that the company continues to receive net premiums of $100,000 attributable to such contracts for 15 years, the cumulative amount of these deductions is $30,000 ($2,000 for 15 years). If, in the sixteenth year, net premiums attributable to such contracts amount to $60,000, no deduction shall be allowed under section 809(d)(6) and this subparagraph since the cumulative amount of these deductions ($30,000) equals 50 percent of the current year's premiums ($60,000) from such contracts.

(ii) In computing the deduction under section 809(d)(6), the determination as to when the 50 percent limitation on such deduction has been reached shall be based upon the amount allowed as a deduction for the taxable year and all preceding taxable years after the application of the limitation provided in section 809(f) and § 1.809–7. Thus, if in the example set forth in paragraph (c) of § 1.809–7 the application of the limitation provided by section 809(f) limited the deduction allowed for the taxable year under section 809(d)(6) to $3,250,000, then for purposes of determining the 50 percent limitation on such deduction, only $3,250,000 (the amount allowed) shall be taken into account.

(iii) For purposes of determining whether the 50 percent limitation applies to any taxable year, the deduction provided by section 809(d)(6) for all preceding taxable years shall be taken into account, irrespective of whether or not the life insurance company claimed a deduction for these amounts for such preceding taxable years.

(iv) See section 809(f) and § 1.809–7 for limitation of the deduction provided by this subparagraph.

(7) *Assumption by another person of liabilities under insurance, etc., contracts.* (i) The consideration (other than consideration arising out of reinsurance ceded as defined in paragraph (a)(1)(iii) of § 1.809–4) in respect of the assumption by another person of liabilities under insurance and annuity contracts (including contracts supplementary thereto) of the taxpayer.

(ii) For purposes of section 809(d)(7) and this subparagraph, the term "assumption reinsurance" means an arrangement whereby another person (the reinsurer) becomes solely liable to the policyholders on the contracts transferred by the taxpayer. Such term does not include indemnity reinsurance or reinsurance ceded (as defined in paragraph (a)(1)(iii) of § 1.809–4).

(iii) The provisions of section 809(d)(7) and this subparagraph may be illustrated by the following example:

Example. During the taxable year 1958, T, a life insurance company, transferred a block of insurance policies and made a payment of $50,000 to R, a life insurance company, under an arrangement whereby R became solely liable to the policyholders on the policies transferred by T. Under the provisions of section 809(d)(7) and this subparagraph, T is allowed a deduction of $50,000 for the taxable year 1958. For the treatment by R of this $50,000 payment, see section 809(c)(1) and paragraph (a)(1)(i) of § 1.809–4. See section 806(a) and § 1.806–3 for the adjustments in reserves and assets to be made by T and R as a result of this transaction.

(8) *Tax-exempt interest, dividends, etc.* (i) Each of the following items:

(a) The life insurance company's share of interest which under section 103 is excluded from gross income;

(b) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3) and paragraph (d)(2)(i) of § 1.804–2) computed with respect to the life insurance company's share of such interest; and

(c) The deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B) and subdivision (ii) of this subparagraph) computed with respect to the life insurance company's share of the dividends received.

(ii) The modification contained in section 809(d)(8)(B) provides the method for applying section 246(b) (relating to limitation on aggregate amount of deductions for dividends received) for purposes of section 809(d)(8)(A)(iii) and subdivision (i)(c) of this subparagraph. Under this method, the sum of the deductions allowed by sections 243(a) (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock), and 245 (relating to dividends received from certain foreign corporations) shall be limited to 85 percent of the gain from operations computed without regard to:

(a) The deductions provided by section 809(d)(3), (5), and (6);

(b) The operations loss deduction provided by section 812; and

(c) The deductions allowed by sections 243(a), 244, and 245.

If a life insurance company has a loss from operations (as determined under section 812) for the taxable year, the limitation provided in section 809(d)(8)(B) and this subdivision shall not be applicable for such taxable year. In that event, the deductions provided by sections 243(a), 244, and 245 shall be allowable for all tax purposes to the life insurance company for such taxable year without regard to such limitation. If the life insurance company does not have a loss from operations for the taxable year, however, the limitation shall be applicable for all tax purposes for such taxable year. In determining whether a life insurance company has a loss from operations for the taxable year under section 812, the deductions allowed by sections 243(a), 244, and 245 shall be computed without regard to the limitation provided in section 809(d)(8)(B) and this subdivision. For an example of the operation of this rule, see paragraph (b) of §1.812-3.

(9) *Investment expenses, etc.* (i) The amount of investment expenses to the extent not allowed as a deduction under section 804(c)(1) in computing investment yield. For example, if a deduction in the amount of $100,000 is claimed for investment expenses, which amount includes general expenses assigned to or included in investment expenses, and due to the operation of the limitation provided by section 804(c)(1) only $85,000 is allowed, then the excess ($15,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(ii) The amount (if any) by which the sum of the deductions allowable under section 804(c) exceeds the gross investment income. For example, if gross investment income under section 804(b) equals $400,000, and the sum of the deductions allowable under section 804(c) equals $425,000, then the excess ($25,000) shall be allowed as a deduction under section 809(d)(9) and this subparagraph.

(iii) In determining the amount of the deductions allowed under subdivisions (i) and (ii) of this subparagraph, a life insurance company shall first take such deductions to the full extent allowable under section 804(c)(1), and any amount which is allowed as a deduction under section 804(c) shall not again be allowed as a deduction under section 809(d)(9).

(10) *Small business deduction.* The small business deduction as determined under section 804(a)(4).

(11) *Certain mutualization distributions.* The amount of distributions to shareholders actually made by the life insurance company in 1958 and 1959 in acquisition of stock pursuant to a plan of mutualization adopted by the company before January 1, 1958. If such deduction is claimed, there must be attached to the return of the company claiming such deduction a certified copy of the plan of mutualization and proof that such plan was adopted prior to January 1, 1958. See section 809(g) and § 1.809–8 for limitation of such deduction.

(12) *Other deductions.* Except as modified by section 809(e) and § 1.809–6, all other deductions allowed under subtitle A of the Code for purposes of computing taxable income to the extent not allowed as deductions in computing investment yield.

(b) *Denial of double deduction.* Nothing in section 809(d) shall permit the same item to be deducted more than once in determining gain or loss from operations. For example, if an item is allowed as a deduction for the taxable year by reason of its being a loss incurred within such taxable year (whether or not ascertained) under section 809(d)(1), such item, or any portion thereof, shall not also be allowed as a deduction for such taxable year under section 809(d)(2).

§ 1.809–6 Modifications.

Under section 809(e), the deductions allowed under section 809(d)(12) and paragraph (a)(12) of § 1.809–5 (relating to other deductions) are subject to the following modifications—

(a) *Interest.* No deduction shall be allowed under section 163 for interest in respect of items described in section 810(c) since such interest is taken into account in the determination of required interest under section 809.

(b) *Bad debts.* No deduction shall be allowed for an addition to reserves for bad debts under section 166(c). However, a deduction for specific bad debts shall be allowed to the extent that such deduction is allowed under section 166 and the regulations thereunder. In the case of a loss incurred on the sale of mortgaged or pledged property, see § 1.166–6.

(c) *Charitable, etc., contributions and gifts.* (1) The deduction by a life insurance company in any taxable year for a charitable contribution (as defined in section 170(c)) shall be limited to 5 percent of the gain from operations (as determined under section 809(b)(1)), computed without regard to any deductions for:

(i) Charitable contributions under section 170;

(ii) Dividends to policyholders under section 811(b);

(iii) Certain nonparticipating contracts under section 809(d)(5);

(iv) Group life insurance contracts and group accident and health insurance contracts under section 809(d)(6);

(v) Tax-exempt interest, dividends, etc., under section 809(d)(8); and

(vi) Any operations loss carryback to the taxable year under section 812.

(2) In applying the second sentence of section 170(b)(2) (relating to charitable contributions carryovers) as required by section 809(e)(3)(B), any excess of the charitable contributions made by a life insurance company in a taxable year over the amount deductible in such year under the limitation contained in subparagraph (1) of this paragraph, shall be reduced to the extent that such excess:

(i) Reduces life insurance company taxable income (computed without regard to section 802(b)(3)) for the purpose of determining the offsets referred to in section 812(b)(2); and

(ii) Increases an operations loss carryover under section 812 for a succeeding taxable year.

(3) The application of the rules provided in section 809(e)(3) and this paragraph may be illustrated by the following example:

Example. Assume that life insurance company P is organized on January 1, 1958, and has a loss from operations for that year in the amount of $100,000 which is an operations loss carryover to 1959. In 1959, company P has a gain from operations and tax base (computed without regard to section 802(b)(3)) of $100,000 before the allowance of a deduction for a $5,000 charitable contribution made in 1959 and before the application of the operations loss carryover from 1958. Under section 170(b)(2), the operations loss carryover from 1958 is first applied to eliminate the $100,000 gain from operations and tax base in 1959 and the $5,000 charitable contribution carryover would (except for the limitation contained in this paragraph) become a charitable contribution carryover to 1960. However, for the purpose of computing the offsets referred to in section 812(b)(2), the $5,000 charitable contribution is applied to reduce the gain from operations and tax base for 1959 to $95,000 before the application of the operations carryover from 1958. Since only $95,000 of the $100,000 loss from operations in 1958 is an offset for 1959, the remaining $5,000 becomes an operations loss carryover to 1960. Accordingly, under the limitation contained in this paragraph, the charitable contributions carryover provided under the second sentence of section 170(b)(2) is eliminated.

(d) *Amortizable bond premium.* No deduction shall be allowed under section 171 for the amortization of bond premiums since a special deduction for such premiums is specifically taken into account under section 818(b).

(e) *Net operating loss deduction.* No deduction shall be allowed under section 172 since section 812 allows an "operations loss deduction".

(f) *Partially tax-exempt interest.* No deduction shall be allowed under section 242 for partially tax-exempt interest since section 809(d)(8) allows a deduction for such interest.

(g) *Dividends received.* No deduction shall be allowed under sections 243, 244, and 245 for dividends received since section 809(d)(8) allows a deduction for such dividends.

§ 1.809–7 Limitation on certain deductions.

(a) *In general.* Section 809(f)(1) limits the deductions under section 809(d)(3), (5), and (6), relating to deductions for dividends to policyholders, certain nonparticipating contracts, and group life, accident, and health insurance contracts, respectively. This limitation provides that the amount of such deductions shall not exceed the sum of (1) the amount (if any) by which the gain from operations for the taxable year (determined without regard to such deductions) exceeds the taxpayer's taxable investment income for such year, plus (2) $250,000.

(b) *Application of limitation.* Section 809(f)(2) provides a priority system for applying the limitation contained in section 809(f)(1) and paragraph (a) of this section. Under this priority system, the limitation shall be applied in the following order:

(1) First to the amount of the deduction under section 809(d)(6) (relating to group life, accident, and health insurance);

(2) Then to the amount of the deduction under section 809(d)(5) (relating to certain nonparticipating contracts); and

(3) Finally to the amount of the deduction under section 809(d)(3) (relating to dividends to policyholders).

(c) *Illustration of principles.* The operation of the limitation and priority system provided by section 809(f) and this section may be illustrated by the following example:

Example. Assume the following facts with respect to M, a life insurance company, for the taxable year 1958:

Gain from operations computed without regard to the deductions under sec. 809(d)(3), (5), and (6)	$100,000,000
Taxable investment income	83,000,000
Tentative deduction for group life, accident, and health insurance under sec. 809(d)(6)	4,000,000
Tentative deduction for certain nonparticipating contracts under sec. 809(d)(5)	6,000,000
Tentative deduction for dividends to policyholders under sec. 809(d)(3)	10,000,000

In order to determine the limitation on the deductions under section 809(d)(3), (5), and (6), M would make up the following schedule:

(1) Statutory amount provided under sec. 809(f)(1)		$250,000
(2) Gain from operations computed without regard to the deductions under sec. 809(d)(3), (5), and (6)	$100,000,000	
(3) Taxable investment income	83,000,000	
(4) Excess of item (2) over item (3)		17,000,000
(5) Limitation on deductions under sec. 809(d)(3), (5), and (6) (item (1) plus item (4))		17,250,000

Since the total tentative deductions under section 809(d)(3), (5), and (6) ($20,000,000) exceeds the limitation on such deductions ($17,250,000), M would make up the following schedule to determine the application of the priority system:

(6) Maximum possible deduction under sec. 809(d)(3), (5), and (6) (item (5))	$17,250,000
(7) Deduction for group life, accident, and health insurance under sec. 809(d)(6) (not in excess of item (6))	4,000,000
(8) Maximum possible deduction under sec. 809(d)(5) (item (6) less item (7))	13,250,000
(9) Deduction for certain nonparticipating contracts under sec. 809(d)(5) (not in excess of item (8))	6,000,000
(10) Maximum possible deduction under sec. 809(d)(3) (item (8) less item (9))	7,250,000
(11) Deduction for dividends to policyholders under sec. 809(d)(3) (not in excess of item (10))	7,250,000

Thus, as a result of the application of the limitation and priority system for the taxable year 1958, M shall be allowed a deduction of $4,000,000 under section 809(d)(6), $6,000,000 under section 809(d)(5), and only $7,250,000 of the $10,000,000 tentative deduction under section 809(d)(3).

§ 1.809–8 Limitation on deductions for certain mutualization distributions.

(a) *Deduction not to reduce taxable investment income.* Section 809(g)(1) limits the deduction under section 809(d)(11) for certain mutualization distributions. This limitation provides that such deduction shall not exceed the amount (if any) by which the gain from operations for the taxable year, computed without regard to such deduction (but after the application of the limitation contained in section 809(f) and § 1.809–7), exceeds the taxpayer's taxable investment income for such year.

(b) *Deduction not to reduce tax below that imposed by 1957 law.* Section 809(g)(2) further limits the deduction under section 809(d)(11). Under section 809(g)(2), such deduction shall be allowed only to the extent that it (after the application of all other deductions) does not reduce the tax imposed by section 802(a)(1) for the taxable year below the amount of tax which would have been imposed for such taxable year if the law in effect for 1957 applied for such taxable year. If such deduction is claimed for 1958 (or 1959), the company shall attach to its return a schedule showing what its tax for 1958 (or 1959) would have been had such tax been computed under the law in effect for 1957.

(c) *Application of section 815.* Section 809(g)(3) provides that any portion of a distribution which is allowed as a deduction under section 809(d)(11) shall not be treated as a distribution to shareholders for purposes of section 815; except that in the case of any distributions made in 1959, such portion shall be treated as a distribution with respect to which a reduction is required under section 815(e)(2)(B) (relating to adjustment in allocation ratio for certain distributions after December 31, 1958).

§ 1.810 Statutory provisons; life insurance companies; rules for certain reserves.

SEC. 810. *Rules for certain reserves*—(a) *Adjustment for decrease.* If the sum of the items described in subsection (c) as of the beginning of the taxable year exceeds the sum of such items as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the excess shall be taken into account as a net decrease referred to in section 809(c)(2).

(b) *Adjustment for increase.* If the sum of the items described in subsection (c) as of the close of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items as of the beginning of the taxable year, the excess shall be taken into account as a net increase referred to in section 809(d)(2).

(c) *Items taken into account.* The items referred to in subsections (a) and (b) are as follows:

(1) The life insurance reserves (as defined in section 801(b)).

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2).

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this paragraph) life, health, or accident contingencies.

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto).

(5) Premiums received in advance, and liabilities for premium deposit funds.

In applying this subsection, the same item shall be counted only once.

(d) *Adjustment for change in computing reserves*—(1) *In general.* If the basis for determining any item referred to in subsection (c) as of the close of any taxable year differs from the basis for such determination as of the close of the preceding taxable year, then so much of the difference between—

(A) The amount of the item at the close of the taxable year, computed on the new basis, and

(B) The amount of the item at the close of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account for purposes of this subpart as follows:

(i) If the amount determined under subparagraph (A) exceeds the amount determined under subparagraph (B), 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a net increase to which section 809(d)(2) applies; or

(ii) If the amount determined under subparagraph (B) exceeds the amount determined under subparagraph (A), 1/10 of such excess shall be taken into account for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) applies.

(2) *Termination as life insurance company.* Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments under this paragraph shall be taken into account for the preceding taxable year.

(3) *Effect of preliminary term election.* An election under section 818(c) shall not be treated as a change in the basis for determining an item referred to in subsection (c) to which this subsection applies. If an election under section 818(c) applies for the taxable year, the amounts of the items referred to in subparagraphs (A) and (B) of paragraph (1) shall be determined without regard to such election. If such an election would apply in respect of such item for the taxable year but for the new basis, the amount of the item referred to in subparagraph (B) shall be determined on the basis which would have been applicable under section 818(c) if the election applied in respect of the item for the taxable year.

(e) *Certain decreases in reserves of voluntary employees' beneficiary associations*—(1) *Decreases due to voluntary lapses of policies issued before January 1, 1958.* For purposes of subsections (a) and (b), in the case of a life insurance company which meets the requirements of section 501(c)(9) other than the requirement of subparagraph (B) thereof, there shall be taken into account only 11½ percent of any decrease in the life insurance reserve on any policy issued before January 1, 1958, which is attributable solely to the voluntary lapse of such policy on or after January 1, 1958. In applying the preceding sentence, the decrease in the reserve for any policy shall be determined by reference to the amount of such reserve as of the beginning of the taxable year, reduced by any amount allowable as a deduction under section 809(d)(1) in respect of such policy by reason of such lapse. This paragraph shall apply for any taxable year only if the taxpayer has made an election under paragraph (3) which is effective for such taxable year.

(2) *Disallowance of carryovers from pre-1958 losses from operations.* In the case of a life insurance company to which paragraph (1) applies for the taxable year, section 812(b)(1) shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(3) *Election.* Paragraph (1) shall apply to any taxpayer for any taxable year only if the taxpayer elects, not later than the time prescribed by law (including extensions thereof) for filing the return for such taxable year, to have such paragraph apply. Such election shall be made in such manner as the Secretary or his delegate shall prescribe by regulations. Such election shall be effective for the taxable year for which made and for all succeeding taxable years, and shall not be revoked except with the consent of the Secretary or his delegate.

[Sec. 810 as added by sec. 2, Life Insurance Company Income Tax Act 1959 (73 Stat. 125)]

§ 1.810–1 Taxable years affected.

Sections 1.810–2 through 1.810–4 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

§ 1.810–2 Rules for certain reserves.

(a) *Adjustment for decrease or increase in certain reserve items*—(1) *Adjustment for decrease.* Section 810(a) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year exceeds the sum of such items at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)), the amount of such excess shall be taken into account as a net decrease referred to in section 809(c)(2) and paragraph (a)(2) of § 1.809–4 in determining gain or loss from operations.

(2) *Adjustment for increase.* Section 810(b) provides that if the sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year (reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1)) exceeds the sum of such items at the beginning of the taxable year, the amount of such excess shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations.

(b) *Items taken into account.* The items described in section 810(c) and referred to in section 810 (a) and (b) and paragraph (a) of this section are:

(1) The life insurance reserves (as defined in section 801(b) and § 1.801–4);

(2) The unearned premiums and unpaid losses included in total reserves under section 801(c)(2) and § 1.801–5;

(3) The amounts (discounted at the rates of interest assumed by the company) necessary to satisfy the obligations under insurance or annuity contracts (including contracts supplementary thereto), but only if such obligations do not involve (at the time with respect to which the computation is made under this subparagraph) life, health, or accident contingencies;

(4) Dividend accumulations, and other amounts, held at interest in connection with insurance or annuity contracts (including contracts supplementary thereto); and

(5) Premiums received in advance, and liabilities for premium deposit funds.

For purposes of this paragraph, the same item shall be counted only once and deficiency reserves (as defined in section 801(b)(4) and paragraph (e)(4) of § 1.801–4) shall not be taken into account.

(c) *Special rules.* For purposes of section 810 (a) and (b) and paragraph (a) of this section, in determining whether there is a net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year, the following rules shall apply:

(1) *Computation of net increase or decrease in reserves.* The sum of the items described in section 810(c) and paragraph (b) of this section at the beginning of the taxable year shall be the aggregate of the sums of each of such items at the beginning of the taxable year. The sum of the items described in section 810(c) and paragraph (b) of this section at the end of the taxable year shall be the aggregate of the sums of each of such items at the end of the taxable year. However, in order to determine whether there is a net increase or decrease in such items for the taxable year, the aggregate of the sums of the items at the end of the taxable year must first be reduced by the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1).

(2) *Effect of change in basis in computing reserves.* Any increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810 (a) or (b) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of § 1.810–3.

(3) *Effect of section 818(c) election.* If a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), the sum of such reserves at the beginning and end of all taxable years (including the first taxable year) for which the election applies shall be the sum of such reserves computed on such net level premium basis.

(4) *Cross references.* See section 810(e) and § 1.810–4 for special rules for determining the net increase or decrease in the sum of the items described in section 810(c) and paragraph (b) of this section in the case of certain voluntary employees' beneficiary associations. For similar special rules in the case of life insurance companies issuing variable annuity contracts, see section 801(g)(4) and the regulations thereunder.

(d) *Illustration of principles.* The provisions of section 810 (a) and (b) and this section may be illustrated by the following examples:

Example (1). Assume the following facts with respect to R, a life insurance company:

Sum of items described in sec. 810(c) (1) through (5) at beginning of taxable year	$940
Sum of items described in sec. 810(c) (1) through (5) at end of taxable year	1,060
Required interest (as defined in sec. 809(a)(2))	70
Investment yield (as defined in sec. 804(c))	100
Amount of investment yield not included in gain or loss from operations for the taxable year by reason of sec. 809(a)(1)	70

In order to determine the adjustment for decrease or increase in the sum of the items described in section 810(c) for the taxable year, R must first reduce the sum of such items at the end of the taxable year ($1,060) by the amount of investment yield ($70) not

included in gain or loss from operations for the taxable year by reason of section 809(a)(1). Since the adjusted sum of such items at the end of the taxable year, $990 ($1,060 minus $70), exceeds the sum of such items at the beginning of the taxable year, $940, the excess of $50 ($990 minus $940) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations.

Example (2). Assume the facts are the same as in example (1), except that the sum of the items described in section 810(c) at the beginning of the taxable year is $1000. Since the sum of the items described in section 810(c) at the beginning of taxable year, $1000, exceeds the sum of such items at the end of the taxable year after adjustment for the amount of investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), $990 ($1060 minus $70), the excess of $10 ($1000 minus $990) shall be taken into account as a net decrease under section 809(c)(2) and paragraph (a)(2) of § 1.809–4 in determining gain or loss from operations.

Example (3). Assume the following facts with respect to S, a life insurance company:

Sum of items described in sec. 810(c)(1) through (5) at beginning of taxable year	$1,970
Sum of items described in sec. 810(c)(1) through (5) at end of taxable year	2,040
Required interest (as defined in sec. 809(a)(2))	60
Investment yield (as defined in sec. 804(c))	40
Amount of investment yield not included in gain or loss from operations by reason of sec. 809(a)(1)	40

Under the provisions of section 809(a)(1), since the required interest ($60) exceeds the investment yield ($40), the share of each and every item of investment yield set aside for policyholders and not included in gain or loss from operations for the taxable year shall be 100 percent. Thus, applying the provisions of section 810 (a) and (b), the sum of the items described in section 810(c) at the end of the taxable year ($2,040) must first be reduced by the entire amount of the investment yield ($40) in order to determine the net increase or decrease in the sum of such items for the taxable year. Since the adjusted sum of such items at the end of the taxable year, $2,000 ($2,040 minus $40), is greater than the sum of such items at the beginning of the taxable year, $1,970, the excess of $30 ($2,000 minus $1,970) shall be taken into account as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations. No additional deduction is allowed under section 809(d) for the amount ($20) by which the required interest exceeds the investment yield for the taxable year.

Example (4). Assume the facts are the same as in example (1), except that as a result of a change in the basis used in computing an item described in section 810(c) during the taxable year, the sum of such items at the end of the taxable year is $1,200. Under the provisions of paragraph (c)(2) of this section, any increase or decrease in the sum of the section 810(c) items for the taxable year which is attributable to a change in the basis used in computing such items during the taxable year shall not be taken into account under section 810 (a) and (b). Thus, for purposes of section 810 (a) and (b), the sum of the items described in section 810(c) at the end of the taxable year shall be $1,060 (the amount computed without regard to the change in basis) and S shall treat the $50 computed in the manner described in example (1) as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations for the taxable year. The amount of the increase in the section 810(c) items which is attributable to the change in basis during the taxable year, $140 ($1,200 minus $1,060), shall be taken into account in the manner prescribed in section 810(d) and paragraph (a) of § 1.810–3.

Example (5). The life insurance reserves of M, a life insurance company, computed with respect to contracts for which such reserves are determined on a recognized preliminary term basis amount to $100 on January 1, 1960, and $110 on December 31, 1960. For the taxable year 1960, M elects to revalue such reserves on a net level premium basis under section 818(c). Such reserves computed under section 818(c) amount to $115 on January 1, 1960, and $127 on December 31, 1960. Under the provisions of paragraph (c)(3) of this section, a company which makes the section 818(c) election must use the net level premium basis in computing the sum of its life insurance reserves at the beginning and end of all taxable years for which the election applies. Thus, for purposes of section 810 (a) and (b), in determining whether there is a net increase or decrease in the sum of the section 810(c) items for the taxable year 1960, M shall include $115 as its reserves with respect to such contracts under section 810(c)(1) at the beginning of the taxable year and $127 as its reserves with respect to such contracts under section 810(c)(1) at the end of the taxable year.

§ 1.810–3 Adjustment for change in computing reserves.

(a) *Reserve strengthening or weakening.* Section 810(d)(1) provides that if the basis for determining any item referred to in section 810(c) and paragraph (b) of § 1.810–2 at the end of any taxable year differs from the basis for such determination at the end of the preceding taxable year, then so much of the difference between—

(1) The amount of the item at the end of the taxable year, computed on the new basis, and

(2) The amount of the item at the end of the taxable year, computed on the old basis,

as is attributable to contracts issued before the taxable year shall be taken into account as follows:

(i) If the amount of the item at the end of the taxable year computed on the new basis exceeds the amount of the item at the end of the taxable year computed on the old basis, 1/10 of such excess shall be taken into account, for each of the succeeding 10 taxable years, as a net increase to which section 809(d)(2) and paragraph (a)(2) of § 1.809–5 applies; or

(ii) If the amount of the item at the end of the taxable year computed on the old basis exceeds the amount of the item at the end of the taxable year computed on the new basis, 1/10 of such excess shall be taken into account, for each of the 10 succeeding taxable years, as a net decrease to which section 809(c)(2) and paragraph (a)(2) of § 1.809–4 applies.

(b) *Illustration of principles.* The provisions of section 810(d)(1) and paragraph (a) of this section may be illustrated by the following examples:

Example (1). Assume that the amount of an item described in section 810(c) of L, a life insurance company, at the beginning of the taxable year 1959 is $100. Assume that at the end of the taxable year 1959, as a result of a change in the basis used in computing such item during the taxable year, the amount of the item (computed on the new basis) is $200 but computed on the old basis would have been $150. Since the amount of the item at the end of the taxable year computed on the new basis, $200, exceeds the amount of the item at the end of the taxable year computed on the old basis, $150, by $50, 1/10 of the amount of such excess, or $5, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1959. Any increase (or decrease) in the sum of the section 810(c) items computed on the old basis at the end of the taxable year 1959 ($150) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items computed on the old basis at the beginning of the taxable year 1959 ($100), shall be taken into account in the manner prescribed in section 810 (a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1959.

Example (2). Assume the facts are the same as in example (1), and that the sum of the items described in section 810(c) (computed on the new basis) is $200 on January 1, 1960, and $260 on December 31, 1960. Under the provisions of section 810(d)(1), as a result of the reserve strengthening attributable to the change in basis which occurred in 1959, L would include $5 (computed in the manner described in example (1)) as a net increase under section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations for 1960. In addition to this amount, any increase (or decrease) in the sum of the items described in section 810(c) at the end of the taxable year 1960 ($260) after adjustment for investment yield not included in gain or loss from operations for the taxable year by reason of section 809(a)(1), over the sum of such items at the beginning of the taxable year 1960 ($200), shall be taken into account in the manner prescribed in section 810 (a) or (b) and § 1.810–2 for purposes of determining L's gain or loss from operations for 1960.

(c) *Termination as life insurance company.* Section 810(d)(2) provides, subject to the provisions of section 381(c)(22) and the regulations thereunder (relating to carryovers in certain corporate readjustments), that if for any taxable year a company which previously was a life insurance company no longer meets the requirements of section 801(a) and paragraph (b) of § 1.801–3 (relating to the definition of a life insurance company), the balance of any adjustments remaining to be made under section 810(d)(1) and paragraph (a) of this section shall be taken into account for the preceding taxable year.

(d) *Illustration of principles.* The provisions of section 810(d)(2) and paragraph (c) of this section may be illustrated by the following example:

Example. Assume the facts are the same as in example (1) of paragraph (b) of this section, except that for the taxable year 1962, L no longer meets the requirements of section 801(a) (relating to the definition of a life insurance company) and that the provisions of section 381(c)(22) are not applicable. Under the provisions of section 810(d)(2), the entire balance of the adjustment remaining to be made with respect to the change in basis which occurred in 1959, 9/10 of $50, or $40, shall be taken into account for the taxable year 1961, the last year L was a life insurance company. Thus, for the taxable year 1961, the total amount to be taken

into account by L as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining its gain or loss from operations shall be $45. Of this amount, $5 (1/10 of $50) represents the amount determined under the provisions of section 810(d)(1), and $40 represents the amount determined under the provisions of section 810(d)(2).

(e) *Effect of preliminary term election.* (1) Section 810(d)(3) provides that if a company which computes its life insurance reserves on a preliminary term basis elects to revalue such reserves on a net level premium basis under section 818(c), such election shall not be treated as a change in basis within the meaning of section 810(d)(1) and paragraph (a) of this section. Thus, any increase or decrease in reserves attributable to such election shall not be taken into account under section 810(d)(1) and paragraph (a) of this section but shall be taken into account in the manner prescribed in section 810 (a) and (b) and paragraph (a) of § 1.810–2. See paragraph (c)(3) of § 1.810–2.

(2) Section 810(d)(3) further provides that where an election under section 818(c) would apply to an item referred to in section 810(c) but for the fact that the basis used in computing such item has actually been changed, any increase or decrease in such item attributable to such actual change in basis shall be subject to the adjustment required under section 810(d)(1) and paragraph (a) of this section. In such a case, however, for purposes of section 810(d)(1)(B) and paragraph (a)(2) of this section, the amount of such item at the end of the taxable year computed on the old basis shall be the amount of such item at the end of the taxable year computed as if the election under section 818(c) applied in respect of such item for the taxable year.

(f) *Illustration of principles.* The provisions of section 810(d)(3) and paragraph (e) of this section may be illustrated by the following examples:

Example (1). Assume that S, a life insurance company which computes its life insurance reserves on a 3-percent assumed rate and the Commissioner's reserve valuation method (one of the recognized preliminary term reserve methods), elects to revalue such reserves on a net level premium method under section 818(c) and that the significant facts are as follows:

	Jan. 1, 1958	Dec. 31, 1958
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	100	118
Reserves at 3-percent assumed rate, after restatement under section 818(c)	110	131

Under the provisions of section 810(d)(3), an election under section 818(c) is not treated as a change in basis for purposes of section 810(d)(1). Accordingly, the increase of $21 ($131 minus $110) attributable to such election shall not be subject to the adjustment provided by section 810(d)(1) but shall be taken into account in the manner prescribed in section 810(b). For purposes of determining the amount to be taken into account under section 810(b), the reserves with respect to the contracts subject to the section 818(c) election shall be $110 at the beginning of the taxable year 1958 and $131 at the end of the taxable year 1958. However, as a result of making the election under section 818(c), the difference ($10) between the reserves computed on the preliminary term basis on January 1, 1958 ($100) and the reserves restated on the net level premium basis on January 1, 1958 ($110) shall not be taken into account under section 809(d) for the year 1958, or for any subsequent taxable year.

Example (2). Assume the facts are the same as in example (1), except that during the taxable year 1959, S actually changed from the preliminary term basis to a net level premium basis which was identical with the net level premium basis used under the section 818(c) election and that the significant facts are as follows:

	Jan. 1, 1959	Dec. 31, 1959
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	118	127
Reserves at 3-percent assumed rate, after restatement under section 818(c)	131	142
Strengthened reserves at 3-percent assumed rate and net level premium method		142

Under the provisions of section 810(d)(3), if a company which has made an election under section 818(c) which has not been revoked actually changes the basis used by it in computing the reserves subject to such election, any increase or decrease in reserves attributable to such change in basis shall be taken into account in the manner prescribed in section 810(d)(1). Since S actually changed to the same basis which it used in computing its reserves under section 818(c), the reserves at the end of the taxable year computed on the new basis ($142) are the same as the reserves at the end of the taxable year computed on the old basis ($142), i.e., the basis which would have applied under section 818(c) if the election applied for 1959. Accordingly, no adjustment under section 810(d)(1) is required.

Example (3). Assume the facts are the same as in example (1), except that during the taxable year 1960, S actually changed the basis used by it in computing its reserves on a certain block of contracts subject to the election under section 818(c) and that the significant facts with respect to this block of contracts are as follows:

	Jan. 1, 1960	Dec. 31, 1960
Book reserves at 3-percent assumed rate, Commissioner's reserve valuation method	50	63
Reserves at 3-percent assumed rate, after restatement under section 818(c)	60	75
Strengthened reserves at 2-percent assumed rate and net level premium method		95

Under the provisions of section 810(d)(3), the amount of the reserves subject to the section 818(c) election at the end of the taxable year computed on the old basis shall be the amount of such reserves at the end of the taxable year determined under section 818(c) ($75). Since the reserves at the end of the taxable year computed on the new basis, $95, exceed the reserves at the end of the taxable year computed on the old basis, $75, by $20, 1/10 of the excess of $20, or $2, shall be taken into account as a net increase referred to in section 809(d)(2) and paragraph (a)(2) of § 1.809–5 in determining gain or loss from operations for each of the 10 taxable years immediately following the taxable year 1960. For purposes of determining whether there is a net increase or decrease in the sum of the items described in section 810(c) for the taxable year 1960 under section 810 (a) or (b), the sum of the reserves with respect to such block of contracts shall be $60 at the beginning of the taxable year and $75 at the end of the taxable year (the amount of such reserves computed under section 818(c) at the beginning and end of the taxable year). The difference ($10) between the reserves computed on the preliminary term basis on January 1, 1960 ($50) and the reserves restated on the net level premium basis on January 1, 1960 ($60) shall not be taken into account under section 809(d) for the year 1960, or for any subsequent taxable year.

§ 1.810–4 Certain decreases in reserves of voluntary employees' beneficiary associations.

(a) *Decreases due to voluntary lapses of policies issued before January 1, 1958.* (1) Section 810(e) provides that if for any taxable year a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes an election in the manner provided in section 810(e)(3) and paragraph (b) of this section, only 11½ percent of any decrease in life insurance reserves (as defined in section 801(b) and § 1.801–4) attributable to the voluntary lapse on or after January 1, 1958, of any policy issued prior to that date shall be taken into account under section 810 (a) or (b) and paragraph (a) of § 1.810–2 in determining the net increase or decrease in the sum of the items described in section 810(c) during the taxable year. In applying the preceding sentence, the decrease in the reserve for any policy shall be determined by reference to the amount of such reserve at the beginning of the taxable year, reduced by any amount allowable as a deduction under section 809(d)(1) and paragraph (a)(1) of § 1.809–5 in respect of such policy by reason of such lapse. The election under section 810(e) shall be adhered to in computing the company's gain or loss from operation for the taxable year for which the election is made and for all subsequent taxable years, unless consent to revoke such election is obtained from the Commissioner.

(2) The application of the election provided under section 810(e) and subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, M, a life insurance company which meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, makes the election under section 810(e). Assume the following facts with respect to a policy issued in 1955 which voluntarily lapsed during the taxable year:

(1) Life insurance reserve on January 1, 1960	$600
(2) Amount allowable as a deduction under sec. 809(d)(1)	200
(3) Decrease in life insurance reserves for sec. 810(e) purposes (item (1) minus item (2))	400
(4) Amount taken into account under sec. 810 (a) and (b) by reason of sec. 810(e) election (11½% ×$400)	46

Under the provisions of section 810(e) and subparagraph (1) of this paragraph, M would include $46 as its life insurance reserve with respect to such policy under section 810(c)(1) at the beginning of the taxable year 1960 for purposes of determining

the net increase or decrease in the sum of the items described in section 810(c) for the taxable year under section 810 (a) or (b).

(b) *Time and manner of making election.* The election provided by section 810(e)(3) shall be made in a statement attached to the life insurance company's income tax return for the first taxable year for which the company desires the election to apply. The return and statement must be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. However, if the last day prescribed by law (including extensions thereof) for filing a return for the first taxable year for which the company desires the election to apply falls before January 20, 1961, the election provided by section 810(e)(3) may be made for such year by filing the statement and an amended return for such taxable year (and all subsequent taxable years for which returns have been filed) before April 21, 1961. The statement shall indicate that the company meets the requirements of section 501(c)(9), other than the requirement of subparagraph (B) thereof, and has made the election provided under section 810(e) and paragraph (a) of this section. The statement shall set forth the following information with respect to each policy described in paragraph (a) of this section which has voluntarily lapsed during such year:

(1) Type of policy.
(2) Date issued.
(3) Date lapsed.
(4) Reason for lapse.
(5) Policy reserve as of beginning of taxable year.
(6) Deduction allowable under section 809(d)(1) and paragraph (a)(1) of § 1.809–5 during taxable year by reason of lapse.
(7) Decrease in policy reserve for section 810(e) purposes (excess of (5) over (6)).

In addition, the statement shall set forth the total of the amounts referred to in subparagraph (7) of this paragraph with respect to all policies described in paragraph (a) of this section which have voluntarily lapsed during the taxable year.

(c) *Scope of election.* An election made under section 810(e)(3) and paragraph (a) of this section shall be effective for the taxable year for which made and for all succeeding taxable years, unless consent to revoke the election is obtained from the Commissioner. However, for taxable years beginning prior to January 20, 1961, a company may revoke the election provided by section 810(e)(3) without obtaining consent from the Commissioner by filing, before April 21, 1961, a statement that the company desires to revoke such election. An amended return reflecting such revocation must accompany the statement for all taxable years for which returns have been filed with respect to such election.

(d) *Disallowance of carryovers from pre-1958 losses from operations.* For any taxable year for which the election provided under section 810(e)(3) and paragraph (b) of this section is effective, the provisions of section 812(b)(1) and § 1.812–4 shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

§ 1.811 Statutory provisions; life insurance companies; dividends to policyholders.

SEC. 811. *Dividends to policyholders*—(a) *Dividends to policyholders defined.* For purposes of this part, the term "dividends to policyholders" means dividends and similar distributions to policyholders in their capacity as such. Such term does not include interest paid (as defined in section 805(e)).

(b) *Amount of deduction*—(1) *In general.* Except as limited by section 809(f), the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders paid during the taxable year—

(A) Increased by the excess of (i) the amounts held at the end of the taxable year as reserves for dividends to policyholders (as defined in subsection (a)) payable during the year following the taxable year, over (ii) such amounts held at the end of the preceding taxable year, or

(B) Decreased by the excess of (i) such amounts held at the end of the preceding taxable year, over (ii) such amounts held at the end of the taxable year.

For purposes of subparagraphs (A) and (B), there shall be included as amounts held at the end of any taxable year amounts set aside, before the 16th day of the third month of the year following such taxable year (or, in the case of a mutual savings bank subject to the tax imposed by section 594, before the 16th day of the fourth month of the year following such taxable year), for payment during the year following such taxable year.

(2) *Certain amounts to be treated as net decreases.* If the amount determined under paragraph (1)(B) exceeds the dividends to policyholders paid during the taxable year, the amount of such excess shall be a net decrease referred to in section 809(c)(2).

[Sec. 811 as added by sec. 2, Life Insurance Company Tax Act 1955 (70 Stat. 44); amended by sec. 2, Life Insurance Company Income Tax Act 1959 (73 Stat. 126)]

§ 1.811–1 Taxable years affected.

Section 1.811–2, except as otherwise provided therein, is applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

§ 1.811–2 Dividends to policyholders.

(a) *Dividends to policyholders defined.* Section 811(a) defines the term "dividends to policyholders", for purposes of part I, subchapter L, chapter 1 of the Code, to mean dividends and similar distributions to policyholders in their capacity as such. The term includes amounts returned to policyholders where the amount is not fixed in the contract but depends on the experience of the company or the discretion of the management. In general, any payment not fixed in the contract which is made with respect to a participating contract (that is, a contract which during the taxable year contains a right to participate in the divisible surplus of the company) shall be treated as a dividend to policyholders. Similarly, any amount refunded or allowed as a rate credit with respect to either a participating or a nonparticipating contract shall be treated as a dividend to policyholders if such amount depends on the experience of the company. However, the term does not include interest paid (as defined in section 805(e) and paragraph (b) of § 1.805–8) or return premiums (as defined in section 809(c) and paragraph (a)(1)(ii) of § 1.809–4). Thus, so-called excess-interest dividends and amounts returned by one life insurance company to another in respect of reinsurance ceded shall not be treated as dividends to policyholders even though such amounts are not fixed in the contract but depend upon the experience of the company or the discretion of the management.

(b) *Amount of deduction*—(1) *In general.* Section 811(b)(1) provides, subject to the limitation of section 809(f), that the deduction for dividends to policyholders for any taxable year shall be an amount equal to the dividends to policyholders paid during the taxable year—

(i) Increased by the excess of the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, or

(ii) Decreased by the excess of the amounts held as reserves for dividends to policyholders at the end of the preceding taxable year for payment during the taxable year, over the amounts held as reserves for dividends to policyholders at the end of the taxable year for payment during the year following the taxable year.

For the rule as to when dividends are considered paid, see section 561 and the regulations thereunder. For the determination of the amounts held as reserves for dividends to policyholders, see paragraph (c) of this section. For special provisions relating to the treatment of dividends to policyholders paid with respect to policies reinsured under modified coinsurance contracts, see section 820(c)(5) and the regulations thereunder.

(2) *Certain amounts to be treated as net decreases.* Section 811(b)(2) provides that if the amount determined under subparagraph (1)(ii) of this paragraph exceeds the dividends to policyholders paid during the taxable year, the amount of such excess shall be a net decrease referred to in section 809(c)(2).

(c) *Reserves for dividends to policyholders defined*—(1) *In general.* The term "reserves for dividends to policyholders", as used in section 811(b)(1)(A) and (B) and paragraph (b)(1) of this section, means only those amounts—

(i) Actually held, or set aside as provided in subparagraph (2) of this paragraph and thus treated as actually held, by the company at the end of the taxable year, and

(ii) With respect to which, at the end of the taxable year or, if set aside, within the period prescribed in subparagraph (2) of this paragraph, the company is under an obligation, which is either fixed

or determined according to a formula which is fixed and not subject to change by the company, to pay such amounts as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following the taxable year.

(2) *Amounts set aside.* (i) In the case of a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), all amounts set aside before the 16th day of the 3d month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(ii) In the case of a mutual savings bank subject to the tax imposed by section 594, all amounts set aside before the 16th day of the 4th month of the year following the taxable year for payment as dividends to policyholders (as defined in section 811(a) and paragraph (a) of this section) during the year following such taxable year shall be treated as amounts actually held at the end of the taxable year.

(3) *1958 reserve for dividends to policyholders.* For purposes of section 811 (b) and paragraph (b) of this section, the amounts held at the end of 1957 as reserves for dividends to policyholders payable during 1958 shall be determined as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied for 1957. Any adjustment in the reserves for dividends to policyholders at the beginning of 1957 required as a result of an understatement or overstatement of such reserves by the company shall be made to the balance of such reserves as of the beginning of 1957. For example, if at the beginning of 1957 the reserves for dividends to policyholders are stated to be $100 and it is subsequently determined that such reserves should have been $90, the reserves at the beginning of 1957 shall be reduced by $10. Under no circumstances shall an adjustment required with regard to the beginning 1957 reserves be made to the reserves at the end of 1957.

(4) *Information to be filed.* Every company claiming a deduction for dividends to policyholders shall keep such permanent records as are necessary to establish the amount of dividends actually paid during the taxable year. Such company shall also keep a copy of the dividend resolution and any necessary supporting data relating to the amounts of dividends declared and to the amounts held or set aside as reserves for dividends to policyholders during the taxable year. The company shall file with its return a concise statement of the pertinent facts relating to its dividend policy for the year, the amount of dividends actually paid during the taxable year, and the amounts held or set aside as reserves for dividends to policyholders during the taxable year.

(d) *Illustration of principles.* The provisions of section 811(b) and this section may be illustrated by the following examples:

Example (1). On December 31, 1959, M, a life insurance company, held $200 as reserves for dividends to policyholders due and payable in 1960. On March 10, 1960, M set aside an additional $50 as reserves for dividends to policyholders due and payable in 1960. During the taxable year 1960, M paid $240 as dividends to its policyholders and at the end of the taxable year 1960, held $175 as reserves for dividends to policyholders due and payable in 1961. No additional amount was set aside before March 16, 1961, as reserves for dividends to policyholders due and payable in 1961. For the taxable year 1960, subject to the limitation of section 809(f), M's deduction for dividends to policyholders is $165, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1960		$240
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–59 (including amounts set aside as provided in paragraph (c)(2) of this section)	$250	
(b) Reserves for dividends to policyholders as of 12–31–60	175	
		75
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		165

Example (2). On December 31, 1960, S, a life insurance company, held $100 as reserves for dividends to policyholders due and payable in 1961. During the taxable year 1961, S paid $125 as dividends to its policyholders and at the end of the taxable year 1961, held $110 as reserves for dividends to policyholders due and payable in 1962. No additional amount was set aside for dividends to policyholders as provided in paragraph (c)(2) of this section before March 16, 1961, or March 16, 1962. For the taxable year 1961, subject to the limitation of section 809(f), S's deduction for dividends to policyholders is $135, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Increased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–61	$110	
(b) Reserves for dividends to policyholders as of 12–31–60	100	
		10
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		135

Example (3). Assume the facts are the same as in example (2), except that on December 31, 1960, the amount held as reserves for dividends to policyholders due and payable in 1961 is $250. For the taxable year 1961, S's deduction for dividends to policyholders is zero, computed as follows:

(1) Dividends paid to policyholders during the taxable year 1961		$125
(2) Decreased by the excess of item (a) over item (b):		
(a) Reserves for dividends to policyholders as of 12–31–60	$250	
(b) Reserves for dividends to policyholders as of 12–31–61	110	
		140
(3) Deduction for dividends to policyholders under sec. 811(b) (computed without regard to the limitation of sec. 809(f))		0

Under the provisions of section 811(b)(2) and paragraph (b)(2) of this section, since the decrease in the reserves for dividends to policyholders during the taxable year, $140 ($250 minus $110), exceeds the dividends to policyholders paid during the taxable year 1961, $125, S shall include $15 (the amount of such excess) as a net decrease under section 809(c)(2) and paragraph (a)(2) of § 1.809–4 in determining its gain or loss from operations for 1961.

§ 1.812 Statutory provisions; life insurance companies; operations loss deduction.

SEC. 812. *Operations loss deduction*—(a) *Deduction allowed.* There shall be allowed as a deduction for the taxable year an amount equal to the aggregate of—

(1) The operations loss carryovers to such year, plus

(2) The operations loss carrybacks to such year.

For purposes of this part, the term "operations loss deduction" means the deduction allowed by this subsection.

(b) *Operations loss carrybacks and carryovers*—(1) *Years to which loss may be carried*—(A) *In general.* The loss from operations for any taxable year (hereinafter in this section referred to as the "loss year") beginning after December 31, 1954, shall be—

(i) An operations loss carryback to each of the 3 taxable years preceding the loss year,

(ii) An operations loss carryover to each of the 5 taxable years following the loss year, and

(iii) Subject to subsection (e), if the life insurance company is a new company for the loss year, an operations loss carryover to each of the 3 taxable years following the 5 taxable years described in clause (ii).

(B) *Special transitional rules for carrybacks.* A loss from operations for any taxable year beginning before January 1, 1958, shall not be an operations loss carryback to any taxable year beginning before January 1, 1955. A loss from operations for any taxable year beginning after December 31, 1957, shall not be an operations loss carryback to any taxable year beginning before January 1, 1958.

(C) *Application for years prior to 1958.* For purposes of this section, this part (as in effect for 1958) and section 381(c)(22) shall be treated as applying to all taxable years beginning after December 31, 1954, and before January 1, 1958.

(2) *Amount of carrybacks and carryovers.* The entire amount of the loss from operations for any loss year shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess (if any) of the amount of such loss over the sum of the offsets (as defined in subsection (d)) for each of the prior taxable years to which such loss may be carried.

(c) *Computation of loss from operations.* In computing the loss from operations for purposes of this section—

(1) The operations loss deduction shall not be allowed.

(2) The deductions allowed by sections 243 (relating to dividends received by corporations), 244 (relating to dividends received on certain preferred stock of public utilities), and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) as modified by section 809(d)(8)(B).

(d) *Offset defined*—(1) *In general.* For purposes of subsection (b)(2), the term "offset" means, with respect to any taxable year, an amount equal to that increase in the operations loss deduction for the taxable year which reduces the life insurance company taxable income (computed without regard to section 802(b)(3)) for such year to zero.

(2) *Operations loss deduction.* For purposes of paragraph (1), the operations loss

deduction for any taxable year shall be computed without regard to the loss from operations for the loss year or for any taxable year thereafter.

(e) *Rules relating to new companies*—(1) *New company defined.* For purposes of this part, a life insurance company is a new company for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or any predecessor, if section 381(c)(22) applies or would have applied if in effect) was authorized to do business as an insurance company.

(2) *Limitations on 8-year carryover*—(A) *In general.* For purposes of subsection (b)(1)(A)(iii), a life insurance company shall not be treated as a new company for any loss year if at any time during such year it was a nonqualified corporation. If, at any time during any taxable year after the loss year, the life insurance company is a nonqualified corporation, subsection (b)(1)(A)(iii) shall cease to apply with respect to such loss for such taxable year and all subsequent taxable years.

(B) *Nonqualified corporation defined.* For purposes of subparagraph (A), the term "nonqualified corporation" means any corporation connected through stock ownership with any other corporation, if either of such corporations possesses at least 50 percent of the voting power of all classes of stock of the other such corporation. For purposes of subparagraph (A), a corporation shall be treated as becoming a nonqualified corporation at any time at which it becomes a party to a reorganization (other than a reorganization which is not described in any subparagraph of section 368(a)(1) other than subparagraphs (E) and (F) thereof.

(f) *Application of subtitle A and subtitle F.* Except as provided in section 809(e), subtitle A and subtitle F shall apply in respect of operations loss carrybacks, operations loss carryovers, and the operations loss deduction under this part in the same manner and to the same extent as such subtitles apply in respect of net operating loss carrybacks, net operating loss carryovers, and the net operating loss deduction.

[Sec. 812 as added by sec. 2, Life Insurance Company Tax Act 1955 (70 Stat. 45); amended by sec. 2, Life Insurance Company Income Tax Act 1959 (73 Stat. 127)]

§ 1.812–1 Taxable years affected.

Sections 1.812–2 through 1.812–8, except as otherwise provided therein, are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

§ 1.812–2 Operations loss deduction.

(a) *Allowance of deduction.* Section 812 provides that a life insurance company shall be allowed a deduction in computing gain or loss from operations for any taxable year beginning after December 31, 1957, in an amount equal to the aggregate of the operations loss carryovers and operations loss carrybacks to such taxable year. This deduction is referred to as the operations loss deduction. The loss from operations (computed under section 809), is the basis for the computation of the operations loss carryovers and operations loss carrybacks and ultimately for the operations loss deduction itself. Section 809(e)(5) provides that the net operating loss deduction provided in section 172 shall not be allowed a life insurance company since the operations loss deduction provided in section 812 and this paragraph shall be allowed in lieu thereof.

(b) *Steps in computation of operations loss deduction.* The three steps to be taken in the ascertainment of the operations loss deduction for any taxable year beginning after December 31, 1957, are as follows:

(1) Compute the loss from operations for any preceding or succeeding taxable year from which a loss from operations may be carried over or carried back to such taxable year.

(2) Compute the operations loss carryovers to such taxable year from such preceding taxable years and the operations loss carrybacks to such taxable year from such succeeding taxable years.

(3) Add such operations loss carryovers and carrybacks in order to determine the operations loss deduction for such taxable year.

(c) *Statement with tax return.* Every life insurance company claiming an operations loss deduction for any taxable year shall file with its return for such year a concise statement setting forth the amount of the operations loss deduction claimed and all material and pertinent facts relative thereto, including a detailed schedule showing the computation of the operations loss deduction.

(d) *Ascertainment of deduction dependent upon operations loss carryback.* If a life insurance company is entitled in computing its operations loss deduction to a carryback which it is not able to ascertain at the time its return is due, it shall compute the operations loss deduction on its return without regard to such operations loss carryback. When the life insurance company ascertains the operations loss carryback, it may within the applicable period of limitations file a claim for credit or refund of the overpayment, if any, resulting from the failure to compute the operations loss deduction for the taxable year with the inclusion of such carryback; or it may file an application under the provisions of section 6411 for a tentative carryback adjustment.

(e) *Law applicable to computations.* The following rules shall apply to all taxable years beginning after December 31, 1957—

(1) In determining the amount of any operations loss carryback or carryover to any taxable year, the necessary computations involving any other taxable year shall be made under the law applicable to such other taxable year.

(2) The loss from operations for any taxable year shall be determined under the law applicable to that year without regard to the year to which it is to be carried and in which, in effect, it is to be deducted as part of the operations loss deduction.

(3) The amount of the operations loss deduction which shall be allowed for any taxable year shall be determined under the law applicable for that year.

(f) *Special rules.* For purposes of taxable years beginning after December 31, 1954, and before January 1, 1958—

(1) The amount of any:

(i) Loss from operations;

(ii) Operations loss carryback; and

(iii) Operations loss carryover

shall be computed as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) and section 381(c)(22) applied to such taxable years.

(2) A loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph) for such taxable years shall in no way affect the tax liability of any life insurance company for such taxable years. However, such loss may, to the extent allowed as an operations loss carryover under section 812, affect the tax liability of a life insurance company for a taxable year beginning after December 31, 1957. For example, for the taxable year 1956, X, a life insurance company, has a loss from operations (determined in accordance with the provisions of section 812(b)(1)(C) and this paragraph). Such loss shall in no way affect X's tax liability for the taxable years 1956 (the year of the loss), 1955 (a year to which such loss shall be carried back), or 1957 (a year to which such loss shall be carried forward). However, to the extent allowed under section 812, any amount of the loss for 1956 remaining after such carryback and carryforward shall be taken into account in determining X's tax liability for taxable years beginning after December 31, 1957.

§ 1.812–3 Computation of loss from operations.

(a) *Modification of deductions.* A loss from operations is sustained by a life insurance company in any taxable year, if and to the extent that, for such year, there is an excess of the sum of the deductions provided by section 809(d) over the sum of (1) the life insurance company's share of each and every item of investment yield (including tax-exempt interest, partially tax-exempt interest, and dividends received) as determined under section 809(b)(3), and (2) the sum of the items of gross amount taken into account under section 809(c). In determining the loss from operations for purposes of section 812—

(i) No deduction shall be allowed under section 812 for the operations loss deduction.

(ii) The 85 percent limitation on dividends received provided by section 246(b) as modified by section 809(d)(8)(B) shall not apply to the deductions otherwise allowed under—

(*a*) Section 243(a) in respect to dividends received by corporations,

(*b*) Section 244 in respect of dividends received on certain preferred stock of public utilities, and

(*c*) Section 245 in respect of dividends received from certain foreign corporations.

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

Example. For the taxable year 1960, X, a life insurance company, has items taken into account under section 809(c) amounting to $150,000, its share of the investment yield amounts to $250,000, and total deductions allowed by section 809(d) of $375,000, ex-

clusive of any operations loss deduction and exclusive of any deduction for dividends received. In 1960, X received as its share of dividends entitled to the benefits of section 243(a) the amount of $100,000. These dividends are included in X's share of the investment yield. X has no other deductions to which section 812(c) applies. On the basis of these facts, X has a loss from operations for the taxable year 1960 of $60,000, computed as follows:

Deductions for 1960	$375,000
Plus: Deduction for dividends received computed without regard to the limitation provided by sec. 246(b), as modified by sec. 809(d)(8)(B) (85% of $100,000)	85,000
Total deductions as modified by sec. 812(c)	460,000
Less: Sum of sec. 809(c) items and X's share of investment yield (including $100,000 of dividends)	400,000
Loss from operations for 1960	(60,000)

§ 1.812–4 Operations loss carrybacks and operations loss carryovers.

(a) *In general*—(1) *Years to which loss may be carried.* In order to compute the operations loss deduction of a life insurance company the company must first determine the part of any losses from operations for any preceding or succeeding taxable years which are carryovers or carrybacks to the taxable year in issue. Except as otherwise provided by this paragraph, a loss from operations for taxable years beginning after December 31, 1954, shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 5 taxable years succeeding the loss year. Except as limited by section 812(e)(2) and paragraph (b) of § 1.812–6, if the life insurance company is a new company (as defined in section 812(e)(1)) for the loss year, the loss from operations shall be carried back to each of the 3 taxable years preceding the loss year and shall be carried forward to each of the 8 taxable years succeeding the loss year. In determining the span of years for which a loss from operations may be carried, taxable years in which a company does not qualify as a life insurance company (as defined in section 801(a)), or is not treated as a new company, shall be taken into account.

(2) *Special transitional rules.* (i) A loss from operations for any taxable year beginning before January 1, 1958, shall not be carried back to any taxable year beginning before January 1, 1955. Furthermore, a loss from operations for any taxable year beginning after December 31, 1957, shall not be carried back to any taxable year beginning before January 1, 1958.

(ii) If for any taxable year a life insurance company has made an election under section 810(e) (relating to certain decreases in reserves for voluntary employees' beneficiary associations) which is effective for such taxable year, the provisions of section 812(b)(1) and subparagraph (1) of this paragraph shall not apply with respect to any loss from operations for any taxable year beginning before January 1, 1958.

(3) *Illustration of principles.* The provisions of section 812(b)(1) and of this paragraph may be illustrated by the following examples:

Example (1). P, a life insurance company, organized in 1940, has a loss from operations of $1,000 in 1958. This loss cannot be carried back, but shall be carried forward to each of the 5 taxable years following 1958.

Example (2). Q, a life insurance company, organized in 1940, has a loss from operations of $1,200 in 1959. This loss shall be carried back to the taxable year 1958 and then shall be carried forward to each of the 5 taxable years following 1959.

Example (3). R, a life insurance company, organized in 1940, has a loss from operations of $1,300 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then shall be carried forward to each of the 5 taxable years following 1956. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I, subchapter L, chapter 1 of the Code (as in effect for 1958) applied to such taxable years.

Example (4). S, a life insurance company, organized in 1958 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,400 for the taxable year 1958. This loss cannot be carried back, but shall be carried forward to each of the 8 taxable years following 1958, provided, however, S is not a nonqualified corporation at any time during the loss year (1958) or any taxable year thereafter.

Example (5). T, a life insurance company, organized in 1954 and meeting the provisions of section 812(e) (rules relating to new companies), has a loss from operations of $1,500 for the taxable year 1956. This loss shall first be carried back to the taxable year 1955 and then carried forward to each of the 8 taxable years following 1956, provided, however, T is not a nonqualified corporation at any time during the loss year (1956) or any taxable year thereafter. The loss for 1956, carryback to 1955, and carryover to 1957 shall each be computed as if part I of subchapter L (as in effect for 1958) applied to such taxable years.

(4) *Periods of less than 12 months.* A fractional part of a year which is a taxable year under sections 441(b) and 7701(a)(23) is a preceding or a succeeding taxable year for the purpose of determining under section 812 the first, second, etc., preceding or succeeding taxable year. For the determination of the loss from operations for periods of less than 12 months, see section 818(d) and the regulations thereunder.

(5) *Amount of loss to be carried.* The amount which is carried back or carried over to any taxable year is the loss from operations to the extent it was not absorbed in the computation of gain from operations for other taxable years, preceding such taxable year, to which it may be carried back or carried over. For the purpose of determining the gain from operations for any such preceding taxable year, the various operations loss carryovers and carrybacks to such taxable year are considered to be applied in reduction of the gain from operations in the order of the taxable years from which such losses are carried over or carried back, beginning with the loss for the earliest taxable year.

(6) *Corporate acquisitions.* For the computation of the operations loss carryovers in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

(b) *Portion of loss from operations which is a carryback or a carryover to the taxable year in issue*—(1) *Manner of computation.* (i) A loss from operations shall first be carried back to the earliest taxable year permissible under section 812(b) and paragraph (a) of this section for which such loss is allowable as a carryback or a carryover. The entire amount of the loss from operations shall be carried back to such earliest year.

(ii) Section 812(b)(2) provides that the portion of the loss from operations which shall be carried to each of the taxable years subsequent to the earliest taxable year shall be the excess (if any) of the amount of the loss from operations over the sum of the offsets (as defined in section 812(d) and paragraph (a) of § 1.812–5) for all prior taxable years to which the loss from operations may be carried.

(2) *Illustration of principles.* The application of this paragraph may be illustrated by the following example:

Example. T, a life insurance company (which is not a new company as defined in section 812(e)(1)), has a loss from operations for 1960. The entire amount of the loss from operations for 1960 shall first be carried back to 1958. The amount of the carryback to 1959 is the excess (if any) of the 1960 loss over the offset for 1958. The amount of the carryover to 1961 is the excess (if any) of the 1960 loss over the sum of the offsets for 1958 and 1959. The amount of the 1960 loss remaining (if any) to be carried over to 1962, 1963, or 1964 shall be computed in a like manner.

§ 1.812–5 Offset.

(a) *Offset defined.* Section 812(d) defines the term "offset" for purposes of section 812(b)(2) and paragraph (b)(1)(ii) of § 1.812–4. For any taxable year the offset is only that portion of the increase in the operations loss deduction for the taxable year which is necessary to reduce the life insurance company taxable income (computed without regard to section 802(b)(3)) for such year to zero. For purposes of the preceding sentence, the offset shall be determined with the modifications prescribed in paragraph (b) of this section. Such modifications shall be made independently of, and without reference to, the modifications required by paragraph (a) of § 1.812–3 for purposes of computing the loss from operations itself.

(b) *Modifications*—(1) *Operations loss deduction*—(i) *In general.* Section 812(d)(2) provides that for purposes of section 812(d)(1) (relating to the definition of offset), the operations loss deduction for any taxable year shall be computed by taking into account only such losses from operations otherwise allowable as carryovers or as carrybacks to such taxable year as were sustained in taxable years preceding the taxable year in which the life insurance company sustained the loss from operations from which the offset is to be deducted. Thus, for such purposes the loss from operations for the loss year or for any taxable year thereafter shall not be taken into account.

(ii) *Illustration of principles.* The provisions of this subparagraph may be illustrated by the following example:

Example. In computing the operations loss deduction for 1960, Y, a life insurance company, has a carryover from 1958 of $9,000, a carryover from 1959 of $6,000, a carryback from 1961 of $18,000, and a carryback from 1962 of $10,000, or an aggregate of $43,000 in carryovers and carrybacks. Thus, the operations loss deduction for 1960, for purposes of determining the tax liability for 1960, is $43,000. However, in computing the offset for 1960 which is subtracted from the loss from operations for 1961 for the purpose of determining the portion of such loss which may be carried over to subsequent taxable years, the operations loss deduction for 1960 is $15,000, that is, the aggregate of the $9,000 carryover from 1958 and the $6,000 carryover from 1959. In computing the operations loss deduction for such purpose, the $18,000 carryback from 1961 and the $10,000 carryback from 1962 are disregarded. In computing the offset for 1960, however, which is subtracted from the loss from operations for 1962 for the purpose of determining the portion of such 1962 loss which may be carried over for subsequent taxable years, the operations loss deduction for 1960 is $33,000, that is, the aggregate of the $9,000 carryover from 1958, the $6,000 carryover from 1959, and the $18,000 carryback from 1961. In computing the operations loss deduction for such purpose, the $10,000 carryback from 1962 is disregarded.

(2) *Recomputation of deductions limited by section 809(f)*—(i) *In general.* If in any taxable year a life insurance company has deductions under section 809(d) (3), (5), and (6), as limited by section 809(f), and sustains a loss from operations in a succeeding taxable year which may be carried back as an operations loss deduction, such limitation and deductions shall be recomputed. This recomputation is required since the carryback must be taken into account for purposes of determining such limitation and deductions.

(ii) *Illustration of principles.* The provisions of this subparagraph may be illustrated by the following example:

(*a*) *Facts.* The books of P, a life insurance company, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1959	$9,000,000	$10,000,000	
1960			($9,800,000)

The gain from operations thus shown is computed without regard to any operations loss deduction or deductions under section 809(d) (3), (5), and (6), as limited by section 809(f). Assume that for the taxable year 1959, P has (without regard to the limitation of section 809(f) or the operations loss deduction for 1959) a deduction under section 809(d)(3) of $2,500,000 for dividends to policyholders and no deductions under section 809(d) (5) or (6).

(*b*) *Determination of section 809(f) limitation and deduction for dividends to policyholders without regard to the operations loss deduction for 1959.* In order to determine gain or loss from operations for 1959, P must determine the deduction for dividends to policyholders for such year. Under the provisions of section 809(f), the amount of such deduction shall not exceed the sum of (*1*) the amount (if any) by which the gain from operations for such year (determined without regard to such deduction) exceeds P's taxable investment income for such year, plus (2) $250,000. Since the gain from operations as thus determined ($10,000,000) exceeds the taxable investment income ($9,000,000) by $1,000,000, the limitation on such deduction is $1,250,000 ($1,000,000 plus $250,000). Accordingly, only $1,250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year is $8,750,000 ($10,000,000 minus $1,250,000).

(*c*) *Recomputation of section 809(f) limitation and deduction for dividends to policyholders after application of the operations loss deduction for 1959.* Since P has sustained a loss from operations for 1960 which shall be carried back to 1959 as an operations loss deduction, it must recompute the section 809(f) limitation and deduction for dividends to policyholders. Taking into account the $9,800,000 operations loss deduction for 1959 reduces gain from operations for such year to $200,000 ($10,000,000 minus $9,800,000). Since the gain from operations as thus determined ($200,000) is less than the taxable investment income ($9,000,000), the limitation on the deduction for dividends to policyholders is $250,000. Thus, only $250,000 of the $2,500,000 deduction for dividends to policyholders shall be allowed. The gain from operations for such year as thus determined is $9,750,000 ($10,000,000 minus $250,000) since for purposes of this determination the operations loss deduction for 1959 is not taken into account (see section 812(c)(1)). Accordingly, the offset for 1959 is $9,750,000 (the increase in the operations loss deduction for 1959, computed without regard to the carryback for 1960, which reduces life insurance company taxable income for 1959 to zero); thus, the portion of the 1960 loss from operations which shall be carried forward to 1961 is $50,000 (the excess of the 1960 loss ($9,800,000) over the offset for 1959 ($9,750,000)).

(3) *Minimum limitation.* The life insurance company taxable income, as modified under this paragraph, shall in no case be considered less than zero.

§ 1.812–6 Rules relating to new companies.

(a) *New company defined.* Section 812(e)(1) provides that for purposes of part I, subchapter L, chapter 1 of the Code, a life insurance company is a "new company" for any taxable year only if such taxable year begins not more than 5 years after the first day on which it (or any predecessor, if section 381(c)(22) applies or would have applied if in effect) was authorized to do business as an insurance company.

(b) *Limitations on 8-year carryover.* (1) Section 812(e)(2)(A) provides that for purposes of section 812(b)(1)(A)(iii) (relating to an 8-year carryover of losses for new companies), a life insurance company shall not be treated as a new company for any loss year if at any time during such loss year it was a nonqualified corporation (as defined in subparagraph (2) of this paragraph). Furthermore, if at any time during any taxable year after the loss year the life insurance company is a nonqualified corporation, section 812(b)(1)(A)(iii) shall cease to apply to (i) such loss for the taxable year of the nonqualification, and (ii) all subsequent taxable years.

(2) Section 812(e)(2)(B) defines the term "nonqualified corporation" for purposes of section 812(e)(2)(A) as any corporation connected through stock ownership with any other corporation where either of such corporations possesses at least 50 percent of the total combined voting power of all classes of stock entitled to vote of the other corporation. For such purpose, a corporation shall be treated as becoming a nonqualified corporation at any time it becomes a party to a reorganization other than a reorganization described in section 368(a)(1) (E) or (F).

(c) *Illustration of principles.* The provisions of section 812(e) and this section may be illustrated by the following examples:

Example (1). R, a life insurance company, organized on January 1, 1958, and qualifying as a new company, had a loss from operations for the taxable year 1958. Regardless of what events take place in future taxable years, R is a new company for any taxable year beginning not more than 5 years after January 1, 1958. The loss for 1958 may be carried forward to each of the 8 taxable years following 1958, provided, however, R is not a nonqualified corporation at any time during the loss year (1958) or any taxable year thereafter.

Example (2). The facts are the same as in example (1), except that from March 10, 1958 through August 1, 1958, R was a nonqualified corporation. R is still a new company for the taxable year 1958 but shall not be treated as such since it was a nonqualified corporation at some time during such taxable year. Accordingly, the loss for 1958 shall be carried forward to each of the 5 taxable years following 1958, but shall not be carried forward to any of the 3 taxable years following such 5 taxable years.

Example (3). S, a life insurance company organized in 1958, and qualifying as a new company, had a loss from operations for the taxable year 1958. In 1960, S was a nonqualified corporation. Since S was a nonqualified corporation during a taxable year (1960) after the loss year (1958), the loss for 1958 shall be carried forward to each of the 5 taxable years following 1958, but shall not be carried forward to any of the 3 taxable years following such 5 taxable years. In determining the 5 taxable years to which the loss for 1958 may be carried, the taxable year during which S was a nonqualified corporation (1960) shall be taken into account.

Example (4). The facts are the same as in example (3), except that in 1961 S was no longer a nonqualified corporation. With respect to the loss for 1958, the results are the same as in example (3).

Example (5). The facts are the same as in example (4), except that in 1962 S had a loss from operations. With respect to the loss for 1958, the results are the same as in example (4). With respect to the loss for 1962, such loss may be carried forward to each of the 8 taxable years following 1962, provided, however, S is not a nonqualified corporation at any time during the loss year (1962) or any taxable year thereafter.

Example (6). T, a life insurance company, organized on January 1, 1958, and qualifying as a new company, had a loss from operations for the taxable years 1959 and 1964. With respect to the loss for 1959, such loss may be carried forward to each of the 8 taxable years following 1959, provided, however, T is not a nonqualified corporation at any time during the loss year (1959) or any tax-

able year thereafter. With respect to the loss for 1964, such loss may be carried forward to each of the 5 taxable years following 1964, but not to any of the 3 taxable years following such 5 taxable years since the loss for 1964 was sustained in a taxable year beginning more than 5 taxable years after the first day (January 1, 1958) on which T was authorized to do business as an insurnace company.

Example (7). U, a life insurance company, organized in 1958, and qualifying as a new company, had a loss from operations for the taxable year 1958. In 1965, U was a nonqualified corporation. The loss for 1958 shall be carried forward to each of the 6 taxable years following 1958 (1959, 1960, 1961, 1962, 1963, and 1964), but shall not be carried forward to any of the 2 taxable years following such 6 taxable years (1965 and 1966).

§ 1.812–7 Application of subtitle A and subtitle F.

Section 812(f) provides that except as modified by section 809(e) (relating to modifications of deduction items otherwise allowable under subtitle A of the Code) subtitles A and F of the Code shall apply to operations loss carrybacks and carryovers, and to the operations loss deduction, in the same manner and to the same extent that such subtitles apply in respect of net operation loss carrybacks, net operating loss carryovers, and the net operating loss deduction of corporations generally. For the computation of the operations loss carrybacks and carryovers, and of the operations loss deduction in the case of certain acquisitions of the assets of a life insurance company by another life insurance company, see section 381(c)(22) and the regulations thereunder.

§ 1.812–8 Illustration of operations loss carrybacks and carryovers.

The application of § 1.812-4 may be illustrated by the following example:

(a) *Facts.* The books of M, a life insurance company, organized in 1940, reveal the following facts:

Taxable year	Taxable investment income	Gain from operations	Loss from operations
1958	$11,000	$15,000	
1959	23,000	30,000	
1960			($75,000)
1961	25,000	20,000	
1962			(150,000)
1963	22,000	30,000	
1964	40,000	35,000	
1965	62,000	75,000	
1966	25,000	17,000	
1967	39,000	53,000	

The gain from operations thus shown is computed without regard to any operations loss deduction. The assumption is also made that none of the other modifications prescribed in paragraph (b) of § 1.812-5 apply. There are no losses from operations for 1955, 1956, 1957, 1968, 1969, 1970.

(b) *Loss sustained in 1960.* The portions of the $75,000 loss from operations for 1960 which shall be used as carrybacks to 1958 and 1959 and as carryovers to 1961, 1962, 1963, 1964, and 1965 are computed as follows:

(1) *Carryback to 1958.* The carryback to this year is $75,000, that is, the amount of the loss from operations.

(2) *Carryback to 1959.* The carryback to this year is $60,000 (the excess of the loss for 1960 over the offset for 1958), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)		15,000
Carryback		60,000

(3) *Carryover to 1961.* The carryover to this year is $30,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958 and 1959), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Sum of offsets		45,000
Carryover		30,000

(4) *Carryover to 1962.* The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, and 1961), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Sum of offsets		65,000
Carryover		10,000

(5) *Carryover to 1963.* The carryover to this year is $10,000 (the excess, if any, of the loss for 1960 over the sum of the offsets for 1958, 1959, 1961, and 1962), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Less—Continued		
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	$20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Sum of offsets		$65,000
Carryover		10,000

(6) *Carryover to 1964.* The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, and 1963), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction of the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	30,000	
Sum of offsets		95,000
Carryover		0

(7) *Carryover to 1965.* The carryover to this year is $0 (the excess, if any, of the loss from 1960 over the sum of the offsets for 1958, 1959, 1961, 1962, 1963, and 1964), computed as follows:

Loss from operations		$75,000
Less:		
Offset for 1958 (the $15,000 gain from operations for such year computed without the deduction of the carryback from 1960)	$15,000	
Offset for 1959 (the $30,000 gain from operations for such year computed without the deduction for the carryback from 1960 or the carryback from 1962)	30,000	
Offset for 1961 (the $20,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryback from 1962)	20,000	
Offset for 1962 (a year in which a loss from operations was sustained)	0	

Less—Continued	
Offset for 1963 (the $30,000 gain from operations for such year computed without the deduction for the carryover from 1960 or the carryover from 1962)	$30,000
Offset for 1964 (the $35,000 gain from operations for such year computed without the deduction of the carryover from 1960 or the carryover from 1962)	35,000
Sum of offsets	$130,000
Carryover	0

(c) *Loss sustained in 1962.* The portions of the $150,000 loss from operations for 1962 which shall be used as carrybacks to 1959, 1960, and 1961 and as carryovers to 1963, 1964, 1965, 1966, and 1967 are computed as follows:

(1) *Carryback to 1959.* The carryback to this year is $150,000, that is, the amount of the loss from operations.

(2) *Carryback to 1960.* The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the offset for 1959), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	0
Carryback	150,000

(3) *Carryback to 1961.* The carryback to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959 and 1960), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	$0
Offset for 1960 (a year in which a loss from operations was sustained)	0
Sum of offsets	0
Carryback	150,000

(4) *Carryover to 1963.* The carryover to this year is $150,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, and 1961), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	$0
Offset for 1960 (a year in which a loss from operations was sustained)	0
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	$0
Sum of offsets	$0
Carryover	150,000

(5) *Carryover to 1964.* The carryover to this year is $130,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, and 1963), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	$0
Offset for 1960 (a year in which a loss from operations was sustained)	0
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000
Sum of offsets	20,000
Carryover	130,000

(6) *Carryover to 1965.* The carryover to this year is $95,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, and 1964), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	$0
Offset for 1960 (a year in which a loss from operations was sustained)	0
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000
Less—Continued	
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	$35,000
Sum of offsets	$55,000
Carryover	95,000

(7) *Carryover to 1966.* The carryover to this year is $20,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, and 1965), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	$0
Offset for 1960 (a year in which a loss from operations was sustained)	0
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover for such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000
Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1965 not being taken into account)	75,000
Sum of offsets	130,000
Carryover	20,000

(8) *Carryover to 1967.* The carryover to this year is $3,000 (the excess, if any, of the loss from 1962 over the sum of the offsets for 1959, 1960, 1961, 1963, 1964, 1965, and 1966), computed as follows:

Loss from operations	$150,000
Less:	
Offset for 1959 (the $30,000 gain from operations for such year reduced by the carryback to such year of $60,000 from 1960, the carryback from 1962 to 1959 not being taken into account)	$0

Less—Continued	
Offset for 1960 (a year in which a loss from operations was sustained)	$0
Offset for 1961 (the $20,000 gain from operations for such year reduced by the carryover to such year of $30,000 from 1960, the carryback from 1962 to 1961 not being taken into account)	0
Offset for 1963 (the $30,000 gain from operations for such year reduced by the carryover to such year of $10,000 from 1960, the carryover from 1962 to 1963 not being taken into account)	20,000
Offset for 1964 (the $35,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1964 not being taken into account)	35,000
Offset for 1965 (the $75,000 gain from operations for such year reduced by the carryover to such year of $0 from 1960, the carryover from 1962 to 1965 not being taken into account)	75,000
Offset for 1966 (the $17,000 gain from operations for such year computed without the deduction of the carryover from 1962)	17,000
Sum of offsets	$147,000
Carryover	3,000

(d) *Determination of operations loss deduction for each year.* The carryovers and carrybacks computed under paragraphs (b) and (c) of this section are used as a basis for the computation of the operations loss deduction in the following manner:

Taxable year	Carryover		Carryback		Operations loss deductions
	From 1960	From 1962	From 1960	From 1962	
1958			$75,000		$75,000
1959			60,000	$150,000	210,000
1961	$30,000			150,000	180,000
1963	10,000	$150,000			160,000
1964		130,000			130,000
1965		95,000			95,000
1966		20,000			20,000
1967		3,000			3,000

§ 1.813 Statutory provisions; life insurance companies; adjustment for certain reserves.

SEC. 813. *Adjustment for certain reserves.* In the case of a life insurance company writing contracts other than life insurance, annuity, and noncancellable health and accident insurance contracts (including life insurance or annuity contracts combined with noncancellable health and accident insurance), the term "adjustment for certain reserves" means, for purposes of this subpart, an amount equal to 3¼ percent of the unearned premiums and unpaid losses on such other contracts which are not included in life insurance reserves (as defined in section 801(b)). For purposes of this section, such unearned premiums shall not be considered to be less than 25 percent of the net premiums written during the taxable year on such other contracts.

[Sec. 813 as added by sec. 2, Life Insurance Company Tax Act 1955 (70 Stat. 46)]

DISTRIBUTIONS TO SHAREHOLDERS

§ 1.815 Statutory provisions; life insurance companies; distributions to shareholders.

SEC. 815. *Distributions to shareholders*—(a) *General rule.* For purposes of this section and section 802(b)(3), any distribution to shareholders after December 31, 1958, shall be treated as made—

(1) First out of the shareholders surplus account, to the extent thereof,

(2) Then out of the policyholders surplus account, to the extent thereof, and

(3) Finally out of other accounts.

For purposes of this section, the term "distribution" includes any distribution in redemption of stock or in partial or complete liquidation of the corporation, but does not include any distribution made by the corporation in its stock or in rights to acquire its stock, and does not (except for purposes of paragraph (3) and subsection (e)(2)(B)) include any distribution in redemption of stock issued before 1958 which at all times on and after the date of issuance and on and before the date of redemption is limited as to dividends and is callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of the issue price and the amount of any contribution to surplus made by the original purchaser at the time of his purchase.

(b) *Shareholders surplus account*—(1) *In general.* Each stock life insurance company shall, for purposes of this part, establish and maintain a shareholders surplus account. The amount in such account on January 1, 1958, shall be zero.

(2) *Additions to account.* The amount added to the shareholders surplus account for any taxable year beginning after December 31, 1957, shall be the amount by which—

(A) The sum of—

(i) The life insurance company taxable income (computed without regard to section 802(b)(3)),

(ii) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss,

(iii) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)), the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B)), and the amount of interest excluded from gross income under section 103, and

(iv) The small business deduction provided by section 809(d)(10), exceeds

(B) The taxes imposed for the taxable year by section 802(a), determined without regard to section 802(b)(3).

(3) *Subtractions from account*—(A) *In general.* There shall be subtracted from the shareholders surplus account for any taxable year the amount which is treated under this section as distributed out of such account.

(B) *Distributions in 1958.* There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of distributions to shareholders made during 1958.

(c) *Policyholders surplus account*—(1) *In general.* Each stock life insurance company shall, for purposes of this part, establish and maintain a policyholders surplus account. The amount in such account on January 1, 1959, shall be zero.

(2) *Additions to account.* The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of—

(A) An amount equal to 50 percent of the amount by which the gain from operations exceeds the taxable investment income,

(B) The deduction for certain nonparticipating contracts provided by section 809(d)(5) (as limited by section 809(f)), and

(C) The deduction for group life and group accident and health insurance contracts provided by section 809(d)(6) (as limited by section 809(f)).

(3) *Subtractions from account.* There shall be subtracted from the policyholders surplus account for any taxable year an amount equal to the sum of—

(A) The amount which (without regard to subparagraph (B)) is treated under this section as distributed out of the policyholders surplus account, and

(B) The amount (determined without regard to section 802(a)(3)) by which the tax imposed for the taxable year by section 802(a)(1) is increased by reason of section 802(b)(3).

(d) *Special rules*—(1) *Election to transfer amounts from policyholders surplus account to shareholders surplus account*—(A) *In general.* A taxpayer may elect for any taxable year for which it is a life insurance company to subtract from its policyholders surplus account any amount in such account as of the close of such taxable year. The amount so subtracted, less the amount of the tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

(B) *Manner and effect of election.* The election provided by subparagraph (A) shall be made (in such manner and in such form as the Secretary or his delegate may by regulations prescribe) after the close of the taxable year and not later than the time prescribed by law for filing the return (including extensions thereof) for the taxable year. Such an election, once made, may not be revoked.

(2) *Termination as life insurance company*—(A) *Effect of termination.* Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), if—

(i) For any taxable year the taxpayer is not an insurance company, or

(ii) For any two successive taxable years the taxpayer is not a life insurance company,

then the amount taken into account under section 802(b)(3) for the last preceding taxable year for which it was a life insurance company shall be increased (after the application of subparagraph (B)) by the amount remaining in its policyholders surplus account at the close of such last preceding taxable year.

(B) *Effect of certain distributions.* If for any taxable year the taxpayer is an insurance company but not a life insurance company, then any distribution to shareholders during such taxable year shall be treated as made on the last day of the last preceding taxable year for which the taxpayer was a life insurance company.

(3) *Treatment of certain indebtedness.* If—

(A) The taxpayer makes any payment in discharge of its indebtedness, and

(B) Such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959,

then the amount of such payment shall, for purposes of this section and section 802(b)(3), be treated as a distribution in cash to shareholders, but only to the extent that the distribution referred to in subparagraph (B) was treated as made out of accounts other than the shareholders and policyholders surplus accounts.

(4) *Limitation on amount in policyholders surplus account.* There shall be treated as a subtraction from the policyholders surplus account for a taxable year for which the taxpayer is a life insurance company the

amount by which the policyholders surplus account (computed at the end of the taxable year without regard to this paragraph) exceeds whichever of the following is the greatest—

(A) 15 percent of life insurance reserves at the end of the taxable year,

(B) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or

(C) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1).

The amount so treated as subtracted, less the amount of the tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the succeeding taxable year.

(e) *Special rule for certain mutualizations*—(1) *In general.* For purposes of this section and section 802(b)(3), any distribution to shareholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization shall be treated—

(A) First, as made out of paid-in capital and paid-in surplus, to the extent thereof,

(B) Thereafter, as made in two allocable parts—

(i) One part of which is made out of the other accounts referred to in subsection (a)(3), and

(ii) The remainder of which is a distribution to which subsection (a) applies.

(2) *Special rules*—(A) *Allocation ratio.* The part referred to in paragraph (1)(B)(i) is the amount which bears the same ratio to the amount to which paragraph (1)(B) applies as—

(i) The excess (determined as of December 31, 1958, and adjusted to the beginning of the year of the distribution as provided in subparagraph (B)) of the assets over the total liabilities, bears to

(ii) The sum (determined as of the beginning of the year of the distribution) of the excess described in clause (i), the amount in the shareholders surplus account, plus the amount in the policyholders surplus account.

(B) *Adjustment for certain distributions.* The excess described in subparagraph (A)(i) shall be reduced by the aggregate of the prior distributions which have been treated under subsection (a)(3) as made out of accounts other than the shareholders surplus account and the policyholders surplus account.

[Sec. 815 as added by sec. 2, Life Insurance Company Income Tax Act 1959 (73 Stat. 129)]

§ 1.815–1 Taxable years affected.

Sections 1.815–2 through 1.815–6 are applicable only to taxable years beginning after December 31, 1957, and all references to sections of part I, subchapter L, chapter 1 of the Code are to the Internal Revenue Code of 1954, as amended by the Life Insurance Company Income Tax Act of 1959 (73 Stat. 112).

§ 1.815–2 Distributions to shareholders.

(a) *In general.* Section 815 provides that every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain two special surplus accounts for Federal income tax purposes. These special accounts are the shareholders surplus account (as defined in section 815(b) and § 1.815–3) and the policyholders surplus account (as defined in section 815(c) and § 1.815–4). To the extent that a distribution to shareholders (as defined in paragraph (c) of this section) is treated as being made out of the shareholders surplus account, no tax is imposed on the company with respect to such distribution. However, to the extent that a distribution to shareholders is treated as being made out of the policyholders surplus account, the amount subtracted from the policyholders surplus account by reason of such distribution shall be taken into account in determining life insurance company taxable income under section 802(b).

(b) *Priority system for distributions to shareholders.* (1) For purposes of section 815 (other than subsection (e) thereof relating to certain mutualizations) and section 802(b)(3) (relating to the determination of life insurance company taxable income), any distribution made to shareholders after December 31, 1958, shall be treated in the following manner:

(i) Distributions shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815–3);

(ii) Once the shareholders surplus account has been reduced to zero, distributions shall then be treated as being made out of the policyholders surplus account (as defined in section 815(c) and § 1.815–4) until that account has been reduced to zero; and

(iii) Finally, any distributions in excess of the amounts in the shareholders surplus account and the policyholders surplus account shall be treated as being made out of other accounts (as defined in § 1.815–5).

(2) For purposes of subparagraph (1) of this paragraph, in order to determine whether a distribution (or any portion thereof) shall be treated as being made out of the shareholders surplus account, policyholders surplus account, or other accounts, the amount in such accounts at the end of any taxable year shall be the cumulative balance in such accounts at the end of the taxable year, computed without diminution by reason of a distribution (or any portion thereof) during the taxable year which is treated as being made out of such accounts. For example, on January 1, 1960, S, a stock life insurance company, had $1,000 in its shareholders surplus account and $3,000 in its policyholders surplus account. On November 1, 1960, S distributed $4,000 to its shareholders. Under the provisions of section 815(b)(2) and paragraph (b) of § 1.815–3, S added $5,000 to its shareholders surplus account for the taxable year 1960. Since the distributions to shareholders during the taxable year 1960, $4,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions treated as made out of such account during the taxable year, $6,000 ($1,000 plus $5,000), the entire distribution is treated as being made out of the shareholders surplus account.

(3) Except in the case of a distribution in cash and as otherwise provided herein, the amount to be charged to the special surplus accounts referred to in subparagraph (1) of this paragraph with respect to any distributions to shareholders (as defined in section 815(a) and paragraph (c) of this section) shall be the fair market value of the property distributed, determined as of the date of distribution. However, for the amount of the adjustment to earnings and profits reflecting such distributions, see section 312 and the regulations thereunder. For a special rule relating to the determination of the amount to be charged to such special surplus accounts in the case of a distribution by a foreign life insurance company carrying on a life insurance business within the United States, see section 819(c)(1) and the regulations thereunder.

(c) *Distributions to shareholders defined.* (1) Except as provided in subparagraph (2) of this paragraph, the term "distribution", as used in section 815(a) and paragraph (b) of this section, means any distribution of property made by a life insurance company to its shareholders. For purposes of the preceding sentence, the term "property" means any property (including money, securities, and indebtedness to the company) other than stock, or rights to acquire stock, in the company making the distribution. Thus, for example, the term includes a distribution which is considered a dividend under section 316, but is not limited to the extent that such distribution must be made out of the accumulated or current earnings and profits of the company making the distribution. Similarly, there is a distribution within the meaning of this paragraph in any case in which a corporation acquires the stock of a shareholder in exchange for property in a redemption treated as a distribution in exchange for stock under section 302(a) or treated as a distribution of property under section 302(d). For special rules relating to distributions to shareholders in acquisition of stock pursuant to a plan of mutualization, see section 815(e) and paragraph (e) of § 1.815–6.

(2) The term "distribution", as used in section 815(a) and paragraph (b) of this section, does not (except for purposes of section 815(a)(3) and (e)(2)(B)) include any distribution in redemption of stock issued prior to January 1, 1958, where such stock was at all times on and after the date of its issuance and on and before the date of its redemption limited as to the amount of dividends payable and was callable, at the option of the issuer, at a price not in excess of 105 percent of the sum of its issue price plus the amount of contribution to surplus (if any) made by the original purchaser at the time of his purchase.

§ 1.815–3 Shareholders surplus account.

(a) *In general.* Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a shareholders surplus account. This account shall be established as of January 1, 1958, and the beginning or opening balance of the shareholders surplus account on that date shall be zero.

(b) *Additions to shareholders surplus account.* (1) The amount added to the shareholders surplus account for any taxable year beginning after December

31, 1957, shall be the amount by which the sum of—

(i) The life insurance company taxable income (computed without regard to section 802(b)(3)),

(ii) In the case of a taxable year beginning after December 31, 1958, the amount (if any) by which the net long-term capital gain exceeds the net short-term capital loss,

(iii) The deduction for partially tax-exempt interest provided by section 242 (as modified by section 804(a)(3)), the deductions for dividends received provided by sections 243, 244, and 245 (as modified by section 809(d)(8)(B)), and the amount of interest excluded from gross income under section 103, and

(iv) The small business deduction provided by section 809(d)(10),

exceeds the taxes imposed for the taxable year by section 802(a), computed without regard to section 802(b)(3).

(2) For amounts which are to be added to the shareholders surplus account at the beginning of the succeeding taxable year, see section 815(d)(1) and (4) and paragraphs (a) and (d) of § 1.815–6.

(c) *Subtractions from shareholders surplus account*—(1) *In general.* There shall be subtracted from the cumulative balance in the shareholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, the amount which is treated as being distributed out of such account under section 815(a) and paragraph (b) of § 1.815–2.

(2) *Special rule; distributions in 1958.* There shall be subtracted from the shareholders surplus account (to the extent thereof) for any taxable year beginning in 1958 the amount of the distributions to shareholders made by the company during 1958. For example, assume S, a stock life insurance company, had additions to its shareholders surplus account (as determined under section 815(b)(2) and paragraph (b) of this section) for the taxable year 1958 of $10,000, and actually distributed as dividends to its shareholders $8,000 during the year 1958. The balance in S's shareholders surplus account as of January 1, 1959, shall be $2,000. If S had distributed $12,000 as dividends in 1958, the balance in its shareholders surplus account as of January 1, 1959, would be zero and the other accounts referred to in section 815(a)(3) and paragraph (b)(1)(iii) of § 1.815–2 would be reduced by $2,000.

(d) *Illustration of principles.* The application of section 815(b) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Balance in shareholders surplus account as of 1–1–60	$5,000
Life insurance company taxable income computed without regard to sec. 802(b)(3)	4,000
Excess of net long-term capital gain over net short-term capital loss	1,700
Tax-exempt interest included in gross investment income under sec. 804(b)	100
Small business deduction (determined under sec. 809(d)(10))	200
Tax liability under sec. 802(a)(1) and (2) computed without regard to sec. 802(b)(3)	$1,625
Amount distributed to shareholders	9,000

For purposes of determining the amount to be subtracted from its shareholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in shareholders surplus account as of 1–1–60		$5,000
(2) Additions to account:		
(a) Life insurance company taxable income computed without regard to sec. 802(b)(3)	$4,000	
(b) Excess of net long-term capital gain over net short-term capital loss	1,700	
(c) Tax-exempt interest included in gross investment income under sec. 804(b)	100	
(d) Small business deduction (determined under sec. 809(d)(10))	200	
Total	6,000	
Less: Tax liability under sec. 802(a)(1) and (2) computed without regard to sec. 802(b)(3)	1,625	
		4,375
(3) Cumulative balance in shareholders surplus account as of 12–31–60 (item (1) plus item (2))		9,375

Since the amount distributed to shareholders during the taxable year, $9,000, does not exceed the cumulative balance in the shareholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year, $9,375, under the provisions of section 815(a), the entire distribution shall be treated as being made out of the shareholders surplus account. Thus, $9,000 shall be subtracted from the shareholders surplus account (leaving a balance of $375 in such account at the end of the taxable year) and S shall incur no additional tax liability by reason of the distribution to its shareholders during the taxable year 1960.

§ 1.815–4 Policyholders surplus account.

(a) *In general.* Every stock life insurance company subject to the tax imposed by section 802 shall establish and maintain a policyholders surplus account. This account shall be established as of January 1, 1959, and the beginning or opening balance of the policyholders surplus account on that date shall be zero.

(b) *Additions to policyholders surplus account.* The amount added to the policyholders surplus account for any taxable year beginning after December 31, 1958, shall be the sum of—

(1) An amount equal to 50 percent of the amount by which the gain from operations for the taxable year exceeds the taxable investment income,

(2) The deduction allowed or allowable under section 809(d)(5) (as limited by section 809(f)) for certain nonparticipating contracts, and

(3) The deduction allowed or allowable under section 809(d)(6) (as limited by section 809(f)) for group life and group accident and health insurance contracts.

(c) *Subtractions from policyholders surplus account*—(1) *In general.* There shall be subtracted from the cumulative balance in the policyholders surplus account at the end of any taxable year, computed without diminution by reason of distributions made during the taxable year, an amount equal to the sum of—

(i) The amount which (without regard to subdivision (ii) of this subparagraph) is treated under section 815(a) as distributed out of the policyholders surplus account for the taxable year, plus

(ii) The amount (determined without regard to section 802(a)(3)) by which the tax imposed for the taxable year by section 802(a)(1) is increased by reason of section 802(b)(3).

In addition, there shall be subtracted from the policyholders surplus account for the taxable year those amounts which, at the close of the taxable year, are subtracted or treated as subtracted from the policyholders surplus account under section 815(d)(1) and (4) and paragraphs (a) and (d) of § 1.815–6. For purposes of this paragraph, the subtractions from the policyholders surplus account shall be treated as made in the following order:

(*a*) First the amount determined under section 815(c)(3) by reason of distributions to shareholders during the taxable year which are treated as being made out of the policyholders surplus account;

(*b*) Next the amount elected to be subtracted from the policyholders surplus account for the taxable year under section 815(d)(1);

(*c*) Then the amount which is treated as a subtraction from the policyholders surplus account for the taxable year by reason of the limitation provided in section 815(d)(4); and

(*d*) Finally the amount taken into account upon termination as a life insurance company as provided in section 815(d)(2).

(2) *Method of computing amount subtracted from policyholders surplus account*—(i) *Where life insurance company taxable income, computed without regard to section 802(b)(3), exceeds $25,000.* If the life insurance company taxable income for any taxable year computed under section 802(b), computed without regard to section 802(b)(3), exceeds $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate for the taxable year.

(ii) *Where life insurance company taxable income does not exceed $25,000.* If the life insurance company taxable income for any taxable year, computed under section 802(b), does not exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined by multiplying the amount

treated as distributed out of such account by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the normal tax rate for the taxable year.

(iii) *Where life insurance company taxable income, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000.* If the life insurance company taxable income for any taxable year, computed without regard to section 802(b)(3) does not exceed $25,000, but computed with regard to section 802(b)(3) does exceed $25,000, the amount subtracted from the policyholders surplus account shall be determined in the following manner:

(*a*) First, determine the amount by which $25,000 exceeds the amount determined under section 802(b) (1) and (2);

(*b*) Then, multiply the amount determined under (*a*) by a ratio, the numerator of which is 100 percent minus the normal tax rate and the denominator of which is 100 percent;

(*c*) Next, determine the amount by which the amount treated as distributed out of the policyholders surplus account exceeds the amount determined under (*b*) and multiply such excess by a ratio, the numerator of which is 100 percent and the denominator of which is 100 percent minus the sum of the normal tax rate and the surtax rate; and

(*d*) Finally, add the amounts determined under (*a*) and (*c*).

(3) *Illustration of principles.* The application of section 815(c)(3) and subparagraph (2) of this paragraph may be illustrated by the following examples:

Example (1). The life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000 for the taxable year 1959. Assume that of the amount distributed by S to its shareholders during the taxable year, $9,600 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the sum of the normal tax rate (30%) and the surtax rate (22%) in effect for 1959 is 52 percent, S shall subtract $20,000 from its policyholders surplus account for the taxable year 1959, computed as follows:

$$\$9{,}600\times\frac{100}{(100-52)}=\$9{,}600\times\frac{100}{48}=\$20{,}000$$

Of this amount, $9,600 is due to the application of section 815(c)(3)(A) and $10,400 to the application of section 815(c)(3)(B).

Example (2). Assume that for the taxable year 1960, S, a stock life insurance company, has taxable investment income of $1,000 and a gain from operations of $2,000. Assume further that of the amount distributed by S to its shareholders during the taxable year, $3,500 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since S's life insurance company taxable income does not exceed $25,000 for the taxable year and the normal tax rate in effect for 1960 is 30 percent, S shall subtract $5,000 from its policyholders surplus account for the taxable year 1960, computed as follows:

$$\$3{,}500\times\frac{100}{(100-30)}=\$3{,}500\times\frac{100}{70}=\$5{,}000$$

Of this amount, $3,500 is due to the application of section 815(c)(3)(A), and $1,500 to the application of section 815(c)(3)(B).

Example (3). For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), is $10,000. Assume that of the amount distributed by S to its shareholders during the taxable year, $12,000 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Since the life insurance company taxable income of S, computed with regard to section 802(b)(3), exceeds $25,000, in order to determine the amount to be subtracted from its policyholders surplus account, S would make up the following schedule:

(1) $25,000 minus life insurance company taxable income, computed without regard to sec. 802(b)(3) ($25,000 minus $10,000)	$15,000
(2) Item (1) multiplied by 100 percent minus the normal tax rate as in effect for 1960, over 100 percent $\left(\$15{,}000\times\frac{(100-30)}{100}\right)$	10,500
(3) Amount by which the amount treated as distributed out of policyholders surplus account ($12,000) exceeds item (2) ($10,500), multiplied by 100 percent over 100 percent minus the sum of the normal tax rate and the surtax rate as in effect for 1960 $\left(\$1{,}500\times\frac{100}{(100-52)}\right)$	3,125
(4) Item (1) plus item (3) ($15,000 plus $3,125)	18,125

For the taxable year 1960, S shall subtract $18,125 from its policyholders surplus account. Of this amount, $10,500 represents the distribution from the policyholders surplus account which is taxed at a 30 percent tax rate and $1,500 the distribution from the policyholders surplus account which is taxed at a 52 percent tax rate. Thus, of the amount subtracted from the policyholders surplus account for the taxable year 1960, $12,000 is due to the application of section 815(c)(3)(A), and $6,125 to the application of section 815(c)(3)(B).

(d) *Illustration of principles.* The application of section 815(c) and this section may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Taxable investment income	$25,000
Gain from operations	30,000
Tax base (sec. 802(b) (1) and (2))	27,500
Deduction for certain nonparticipating policies provided by sec. 809(d)(5) (as limited by sec. 809(f))	600
Deduction for group policies provided by sec. 809(d)(6) (as limited by sec. 809(f))	400
Amount distributed to shareholders	60,000
Cumulative balance in shareholders surplus account as of 12-31-60	36,000
Balance in policyholders surplus account as of 1-1-60	48,000

For purposes of determining the amount to be subtracted from its policyholders surplus account for the taxable year, S would first make up the following schedule in order to determine the cumulative balance in the policyholders surplus account at the end of the taxable year, computed without diminution by reason of distributions made during the taxable year:

(1) Balance in policyholders surplus account as of 1-1-60		$48,000
(2) Additions to account:		
(a) 50 percent of the amount by which the gain from operations ($30,000) exceeds the taxable investment income ($25,000) (½×$5,000)	$2,500	
(b) The deduction for certain nonparticipating contracts provided by sec. 809(d)(5) (as limited by sec. 809(f))	600	
(c) The deduction for group contracts provided by sec. 809(d)(6) (as limited by sec. 809(f))	400	
		3,500
(3) Cumulative balance in policyholders account as of 12-31-60 (item (1) plus item (2))		51,500

Under the provisions of section 815(a), since the amount distributed to shareholders during the taxable year, $60,000, exceeds the cumulative balance in the shareholders surplus at the end of the taxable year, computed without diminution by reason of distributions during the taxable year, $36,000, the shareholders surplus account shall first be reduced to zero. The remaining $24,000 ($60,000 minus $36,000) of the distribution shall then be treated as made out of the policyholders surplus account. Thus, since the tax base under section 802(b) (1) and (2) is in excess of $25,000, the total amount to be subtracted from the policyholders surplus account at the end of the taxable year would be $50,000 $\left(\$24{,}000\times\frac{100}{(100-52)}\right)$. Of this amount $26,000 ($50,000 minus $24,000) represents the tax on the portion of the distribution to shareholders which is treated as being out of the policyholders surplus account.

(e) *Special rule for 1959 and 1960.* For a special transitional rule applicable to any increase in tax liability under section 802(b)(3) for the taxable years 1959 and 1960 which is due solely to the operation of section 815(c)(3) and this section, see section 802(a)(3) and § 1.802-5.

§ 1.815-5 Other accounts defined.

The term "other accounts", as used in section 815(a)(3) and paragraph (b) of § 1.815-2, means all amounts which are not specifically included in the shareholders surplus account under section 815(b) and paragraph (b) of § 1.815-3, or in the policyholders surplus account under section 815(c) and paragraph (b) of § 1.815-4. Thus, for example, other accounts includes amounts representing the increase in tax due to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the special transitional rule provided in section 802(a)(3) and § 1.802-5, earnings and profits accumulated prior to January 1, 1958, paid-in surplus, capital, etc. To the extent that a distribution (or any portion thereof) is treated as being made out of other accounts, no tax is imposed on the company with respect to such distribution.

§ 1.815–6 Special rules.

(a) *Election to transfer amounts from policyholders surplus account to shareholders surplus account*—(1) *In general.* Section 815(d)(1) permits a life insurance company to elect, after the close of any taxable year for which it is a life insurance company, to subtract any amount (or any portion thereof) in its policyholders surplus account as of the close of the taxable year. The effect of such election is to subject the company to tax on the amounts elected to be subtracted for the taxable year for which the election applies. The amount so subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account as of the beginning of the taxable year following the taxable year for which the election applies and no further tax shall be imposed upon the company if the amount elected to be transferred to the shareholders surplus account is subsequently distributed to shareholders.

(2) *Manner and effect of election.* (i) The election provided by section 815(d)(1) and this section shall be made in a statement attached to the life insurance company's income tax return for any taxable year for which the company desires the election to apply. The statement shall include the name and address of the taxpayer, shall be signed by the taxpayer (or his duly authorized representative), and shall be filed not later than the date prescribed by law (including extensions thereof) for filing the return for such taxable year. In addition, the statement shall indicate that the company has made the election provided under section 815(d)(1) for the taxable year and the amount elected to be subtracted from the policyholders surplus account.

(ii) An election made under section 815(d)(1)(B) and subdivision (i) of this subparagraph shall be effective only with respect to the taxable year for which the election is made. Thus, the company must make a new election for each taxable year for which it desires the election to apply. Once such an election has been made for any taxable year it may not be revoked.

(3) The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. For the taxable year 1960, the life insurance company taxable income of S, a stock life insurance company, computed without regard to section 802(b)(3), exceeds $25,000. Assume that S elects to subtract $20,000 from its policyholders surplus account under section 815(d)(1) for the taxable year. Since S is subject to a 52 percent tax rate, the tax on the amount elected to be subtracted from the policyholders surplus account (as of the close of the taxable year 1960) is $10,400 ($20,000 × 52 percent). Thus, the amount to be added to the shareholders surplus account as of January 1, 1961, is $9,600 (the amount subtracted from the policyholders surplus account by virtue of the section 815(d)(1) election, less the tax imposed upon such amount by reason of section 802(b)(3), or $20,000 minus $10,400).

(b) *Termination as life insurance company*—(1) *Effect of termination.* Except as provided in section 381(c)(22) (relating to carryovers in certain corporate readjustments), section 815(d)(2)(A) provides that if for any taxable year the taxpayer is not an insurance company (as defined in paragraph (a) of § 1.801–3), or if for any two successive taxable years the taxpayer is not a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), the amount taken into account under section 802(b)(3) for the last preceding year for which the company was a life insurance company shall be increased (after the application of section 815(d)(2)(B)) by the entire balance in the policyholders surplus account at the close of such last preceding taxable year.

(2) *Effect of certain distributions.* If for any taxable year the taxpayer is an insurance company (as defined in paragraph (a) of § 1.801–3) but is not a life insurance company (as defined in section 801(a) and paragraph (b) of § 1.801–3), section 815(d)(2)(B) provides that any distribution to shareholders during such taxable year shall be treated as having been made on the last day of the last preceding taxable year for which the company was a life insurance company.

(3) *Examples.* The application of section 815(d)(2) and this paragraph may be illustrated by the following examples:

Example (1). At the end of the taxable year 1959, the balance in the policyholders surplus account of S, a life insurance company within the meaning of section 801(a) and paragraph (b) of § 1.801–3, is $12,000. If S fails to qualify as an insurance company (as defined in paragraph (a) of § 1.801–3) for the taxable year 1960, and section 381(c)(22) does not apply, under the provisions of section 815(d)(2)(A), the entire balance of $12,000 in the policyholders surplus account at the end of 1959, the last year S was a life insurance company, shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

Example (2). Assume the facts are the same as in example (1), except that for the taxable years 1960 and 1961, S qualifies as an insurance company (as defined in paragraph (a) of § 1.801–3) but does not qualify as a life insurance company within the meaning of section 801(a) and paragraph (b) of § 1.801–3. Assume further that as a result of a distribution by S to its shareholders in 1960, $4,800 (as determined under section 815(a) and without regard to section 815(c)(3)(B)) is treated as distributed out of the policyholders surplus account. Under the provisions of section 815(d)(2)(B), if section 381(c)(22) does not apply, any distribution to shareholders during the taxable years 1960 and 1961 shall be treated as having been made on December 31, 1959 (the last day of the last preceding taxable year for which S was a life insurance company). Thus, assuming S is subject to a 52 percent tax rate on additions to life insurance company taxable income, $10,000 ($4,800 plus $5,200, the tax on the portion of the distribution treated as made out of the policyholders surplus account) shall be treated as being subtracted from the policyholders surplus account at the end of 1959 and shall be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959. Under the provisions of section 815(d)(2)(A), the entire balance of $2,000 ($12,000 minus $10,000) in the policyholders surplus account at the end of 1959 (after the application of section 815(d)(2)(B)), shall also be taken into account under section 802(b)(3) for purposes of determining S's tax liability for the taxable year 1959.

(c) *Treatment of certain indebtedness.* Section 815(d)(3) provides that if a taxpayer makes any payment in discharge of its indebtedness and such indebtedness is attributable to a distribution by the taxpayer to its shareholders after February 9, 1959, the amount of such payment shall be treated as a distribution in cash to shareholders both for purposes of section 802(b)(3) and section 815. However, this paragraph shall only apply to the extent that the distribution of such indebtedness to shareholders was treated as being out of accounts other than the shareholders and policyholders surplus accounts at the time of distribution.

(d) *Limitation on amount in policyholders surplus account*—(1) *In general.* Section 815(d)(4) provides a limitation on the amount that any life insurance company may accumulate in its policyholders surplus account. If the policyholders surplus account at the end of any taxable year (computed without regard to this paragraph) exceeds whichever of the following is the greatest—

(i) 15 percent of life insurance reserves (as defined in section 801(b) and paragraph (a) of § 1.801–4) at the end of the taxable year,

(ii) 25 percent of the amount by which the life insurance reserves at the end of the taxable year exceed the life insurance reserves at the end of 1958, or

(iii) 50 percent of the net amount of the premiums and other consideration taken into account for the taxable year under section 809(c)(1),

then such excess shall be treated as a subtraction from the policyholders surplus account as of the end of such taxable year. The amount so treated as subtracted, less the amount of tax imposed with respect to such amount by reason of section 802(b)(3), shall be added to the shareholders surplus account at the beginning of the succeeding taxable year.

(2) *Example.* The application of the limitation contained in subparagraph (1) of this paragraph may be illustrated by the following example:

Example. The books of S, a stock life insurance company, reflect the following items for the taxable year 1960:

Balance in policyholders surplus account, computed without regard to sec. 815(d)(4), as of 12–31–60	$175
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–60	4,500
Life insurance reserves (as defined in sec. 801(b)) as of 12–31–58	3,900
Premiums and other consideration taken into account for the taxable year under sec. 809(c)(1)	310

In order to determine the limitations on the amount that it may accumulate in its policyholders surplus account at the end of the taxable year under section 815(d)(4), S would make up the following schedule:

(1) 15 percent of life insurance reserves at the end of the taxable year (15% × $4,500)	$675

(2) 25 percent of amount by which life insurance reserves at the end of the taxable year ($4,500) exceed life insurance reserves as of 12-31-58 ($3,900) (25% × $600)	$150
(3) 50 percent of premiums and other consideration taken into account under sec. 809(c)(1) for the taxable year (50% × $310)	155
(4) Limitation on policyholders surplus account (the greatest of items (1), (2), or (3))	675

Since the balance in the policyholders surplus account at the end of the taxable year 1960, $175, does not exceed the limitation provided by section 815(d)(4), $675, S is not required to make any further adjustment to its policyholders surplus account at the end of the taxable year.

(e) *Special rule for certain mutualizations*—(1) *In general.* Section 815(e) provides a rule for determining priorities which shall operate in place of section 815(a) and paragraph (b) of § 1.815–2 where a life insurance company makes any distribution to its shareholders after December 31, 1958, in acquisition of stock pursuant to a plan of mutualization. Section 815(e)(1) provides that such a distribution shall first be treated as being made out of paid-in capital and paid-in surplus, and, to the extent thereof, no tax shall be imposed on the company with respect to such distribution. Thereafter, distributions made pursuant to such plan of mutualization shall be treated as made in two allocable parts. One part shall be treated as being made out of other accounts (as defined in § 1.815–5) and the company shall incur no tax with respect to such portion of the distribution. The other part shall be treated as a distribution to which section 815(a) and paragraph (b) of § 1.815–2 applies. Thus, such portion of the distribution shall be treated as first being made out of the shareholders surplus account (as defined in section 815(b) and § 1.815–3), to the extent thereof, and then out of the policyholders surplus account (as defined in section 815(c) and § 1.815–4), to the extent thereof. See paragraph (a) of § 1.815–2. For purposes of this paragraph, a distribution shall be considered as being made pursuant to a plan of mutualization only if the requirements of applicable State law for the adoption of such plan (as, for example, approval by the requisite majority of the board of directors, shareholders, and policyholders) have been fulfilled.

(2) *Allocation ratio.* Section 815(e)(2)(A) provides an allocation ratio which when applied to the amount distributed under a plan of mutualization in excess of the balance in the paid-in capital and paid-in surplus accounts determines the portion of such excess to be treated as distributed out of the shareholders surplus account, policyholders surplus account, or other accounts. The numerator of this ratio is the excess of the assets of the company (as defined in section 805(b)(4) and paragraph (a)(4) of § 1.805–5) over the total liabilities (including reserves), both determined as of December 31, 1958, and adjusted in the manner provided in subparagraph (3) of this paragraph. The denominator of this ratio is the amount included in the numerator plus the amounts in the shareholders surplus account and policyholders surplus account, all determined as of the beginning of the year of the distribution.

(3) *Adjustment for certain distributions.* Section 815(e)(2)(B) provides that if between 1958 and the year of distribution the taxpayer has been treated as having made a distribution (under a plan of mutualization or otherwise) which is treated as a return of paid-in capital and paid-in surplus or as out of other accounts (as defined in § 1.815–5), the aggregate amount of any such prior distributions must be subtracted from the numerator and denominator in all cases where the allocation ratio provided by subparagraph (2) of this paragraph applies.

(f) *Recomputation required as a result of a subsequent loss from operations under section 812*—(1) *In general.* Any amounts added to or subtracted from the special surplus accounts referred to in section 815(a) and paragraph (b) of § 1.815–2 for any taxable year shall be adjusted to the extent necessary to properly reflect a subsequent loss from operations which under section 812 is carried back to the taxable year for which such additions or subtractions were made.

(2) *Example.* The application of subparagraph (1) of this paragraph may be illustrated by the following example:

Example. Assume that for the taxable years 1959 through 1961, the books of S, a stock life insurance company subject to a 30 percent tax rate for all taxable years involved, reflect the following items:

	1959	1960	1961
Taxable investment income	$40.00	$40.00	$40.00
Gain from operations	60.00	60.00	60.00
Tax base (sec. 802(b) (1) and (2))	50.00	50.00	50.00
Tax (sec. 802(b) (1) and (2) base)	15.00	15.00	15.00
Shareholders surplus account—			
At beginning of year	0	35.00	37.00
Added at beginning of year by reason of election under sec. 815(d)(1)	0	7.00	0
Added for year (without regard to election under sec. 815(d)(1))	35.00	35.00	35.00
Subtracted (distributions)	0	40.00	40.00
Policyholders surplus account—			
At beginning of year	0	0	10.00
Added for year	10.00	10.00	10.00
Subtracted (distributions)	0	0	0
Subtracted (by reason of election under sec. 815(d)(1))	10.00	0	0
Tax base (sec. 802(b)(3))	10.00	0	0
Tax (sec. 802(b)(3) base)	3.00	0	0

Assume further that S has a loss from operations for the taxable year 1962 of $25. Under the provisions of section 812, the $25 loss from operations would be carried back to the taxable year 1959 and would reduce the 1959 tax base under section 802(b) (1) and (2) to $35 ($60 minus $25). After adjustments reflecting the 1962 loss from operations, the results for the taxable years 1959 through the beginning of 1962 would be as follows:

	1959	1960	1961	1962
Taxable investment income	$40.00	$40.00	$40.00	
Gain from operations	35.00	60.00	60.00	
Tax base (sec. 802 (b) (1) and (2))	35.00	50.00	50.00	
Tax (sec. 802 (b) (1) and (2) base)	10.50	15.00	15.00	
Shareholders surplus account—				
At beginning of year	0	24.50	19.50	$14.50
Added for year (without regard to election under sec. 815(d)(1))	24.50	35.00	35.00	
Added by reason of election under sec. 815 (d)(1)	0	0	0	
Subtracted (distributions)	0	40.00	40.00	
Policyholders surplus account—				
At beginning of year	0	0	10.00	20.00
Added for year	0	10.00	10.00	
Subtracted (distributions)	0	0	0	
Subtracted (by reason of election under sec. 815(d)(1))	0	0	0	
Tax base (sec. 802(b)(3))	0	0	0	
Tax (sec. 802(b)(3) base)	0	0	0	

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

§ 1.816 Statutory provisions; life insurance companies; foreign life insurance companies.

SEC. 816. *Foreign life insurance companies*—(a) *Carrying on United States insurance business.* A foreign life insurance company carrying on a life insurance business within the United States, if with respect to its United States business it would qualify as a life insurance company under section 801, shall be taxable in the same manner as a domestic life insurance company; except that the determinations necessary for purposes of this subtitle shall be made on the basis of the income, disbursements, assets, and liabilities reported in the annual statement for the taxable year of the United States business of such company on the form approved for life insurance companies by the National Association of Insurance Commissioners.

(b) *No United States Insurance Business.* Foreign life insurance companies not carrying on an insurance business within the United States shall not be taxable under this part but shall be taxable as other foreign corporations.

[Sec. 816 as added by sec. 2, Life Insurance Company Tax Act 1955 (70 Stat. 46)]

(Sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805)

[F.R. Doc. 61–512; Filed, Jan. 19, 1961; 8:46 a.m.]

[T.D. 6537]

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

Departing Aliens

In order to liberalize the requirements imposed on departing aliens in the reg-

ulations under section 6851 of the Internal Revenue Code of 1954, § 1.6851–2 of the Income Tax Regulations (26 CFR Part 1) is amended to read as follows:

§ 1.6851–2 Certificates of compliance with income tax laws by departing aliens.

(a) *In general*—(1) *Requirement.* The rules of this section are applicable to any alien who departs from the United States or any of its possessions after January 20, 1961. Except as provided in subparagraph (2) of this paragraph, no such alien, whether resident or nonresident, may depart from the United States unless he first procures a certificate that he has complied with all of the obligations imposed upon him by the income tax laws. In order to procure such a certificate an alien who intends to depart from the United States (i) must file with the district director for the internal revenue district in which he is located the statements or returns required by paragraph (b) of this section to be filed before obtaining such certificate, (ii) must appear before such district director if the district director deems it necessary, and (iii) must pay any taxes required under paragraph (b) of this section to be paid before obtaining the certificate. Either such certificate of compliance, properly executed, or evidence that the alien is excepted under subparagraph (2) of this paragraph from obtaining the certificate must be presented at the point of departure. An alien who presents himself at the point of departure without a certificate of compliance, or evidence establishing that such a certificate is not required, will be subject at such departure point to examination by an internal revenue officer or employee and to the completion of returns and statements and payment of taxes as required by paragraph (b) of this section.

(2) *Exceptions*—(i) *Diplomatic representatives.* (*a*) Representatives of foreign governments bearing diplomatic passports, whether accredited to the United States or other countries, and members of their households shall not, upon departure from the United States or any of its possessions, be examined as to their liability for United States income tax or be required to obtain a certificate of compliance. If a foreign government does not issue diplomatic passports but merely indicates on passports issued to members of its diplomatic service the status of the bearer as a member of such service, such passports are considered as diplomatic passports for income tax purposes.

(*b*) Likewise, the servant of a representative described in (*a*) of this subdivision who accompanies any individual bearing a diplomatic passport upon departure from the United States or any of its possessions shall not be required, upon such departure, to obtain a certificate of compliance or to submit to examination as to his liability for United States income tax. If the departure of such a servant from the United States or any of its possessions is not made in the company of an individual bearing a diplomatic passport, the servant is required to obtain a certificate of compliance. However, such certificate will be issued to him on Form 2063 without examination as to his income tax liability upon presentation to the district director for the internal revenue district in which the servant is located of a letter from the chief of the diplomatic mission to which the servant is attached certifying (*1*) that the name of the servant appears on the "White List", a list of employees of diplomatic missions, and (*2*) that the servant is not obligated to the United States for any income tax, and will not be so obligated up to and including the intended date of departure.

(*c*) An alien who has filed with the Attorney General the waiver provided for under section 247(b) of the Immigration and Nationality Act (8 U.S.C. 1257(b)) is not entitled to the exception provided by this subdivision.

(ii) *Alien students and industrial trainees.* A certificate of compliance shall not be required, and examination as to United States income tax liability shall not be made, upon the departure from the United States or any of its possessions of—

(*a*) An alien student admitted solely on an F visa who has received no gross income from sources within the United States during the period he is in the United States under such visa, other than allowances to cover the expenses incident to his study in the United States (including expenses for travel, maintenance, tuition) and the value of any services or accommodations furnished to him incident to such study; or

(*b*) An alien industrial trainee admitted solely on an H–3 visa who has received no gross income from sources within the United States during the period he is in the United States under such visa, other than allowances to cover the expenses incident to his training in the United States (including expenses for travel, maintenance) and the value of any services or accommodations furnished to him incident to such training.

(iii) *Other aliens temporarily in the United States.* A certificate of compliance shall not be required, and examination as to United States income tax liability shall not be made, upon the departure from the United States or any of its possessions of an alien hereinafter described in this subdivision, unless the district director has reason to believe that such alien has received taxable income during the taxable year up to and including the date of departure or during the preceding taxable year and that collection of income tax from such alien will be jeopardized by his departure from the United States:

(*a*) An alien visitor for pleasure admitted solely on a B–2 visa;

(*b*) An alien visitor for business admitted on a B–1 visa, or on both a B–1 visa and a B–2 visa, who does not remain in the United States or a possession thereof for a period or periods exceeding a total of 90 days during the taxable year;

(*c*) An alien in transit through the United States or any of its possessions on a C–1 visa or under a contract, including a bond agreement, between a transportation line and the Attorney General pursuant to section 238(d) of the Immigration and Nationality Act (8 U.S.C. 1228(d));

(*d*) An alien who is admitted to the United States on a border-crossing identification card or with respect to whom passports, visas, and border-crossing identification cards are not required, if such alien is a visitor for pleasure, or if such alien is a visitor for business who does not remain in the United States or a possession thereof for a period or periods exceeding a total of 90 days during the taxable year, or if such alien is in transit through the United States or any of its possessions;

(*e*) An alien military trainee admitted to the United States to pursue a course of instruction under the auspices of the Department of Defense who departs from the United States on official military travel orders; or

(*f*) An alien resident of Canada or Mexico who commutes between such country and the United States at frequent intervals for the purpose of employment and whose wages are subject to the withholding of tax.

(b) *Issuance of certificate of compliance*—(1) *In general.* (i) Upon the departure of an alien required to secure a certificate of compliance under paragraph (a) of this section, the district director shall determine whether the departure of such alien jeopardizes the collection of any income tax for the current or the preceding taxable year, but the district director may determine that jeopardy does not exist in some cases. If the district director finds that the departure of such an alien results in jeopardy, the taxable period of the alien will be terminated, and the alien will be required to file returns and make payment of tax in accordance with subparagraph (3)(iii) of this paragraph. On the other hand, if the district director finds that the departure of the alien does not result in jeopardy, the alien will be required to file the statement or returns required by subparagraph (2) or (3)(ii) of this paragraph, but will not be required to pay income tax before the usual time for payment.

(ii) The departure of an alien who is a resident of the United States or a possession thereof and who intends to continue such residence shall be treated as not resulting in jeopardy, and thus not requiring termination of his taxable period, except when the district director has information indicating that the alien intends by such departure to avoid the payment of his income tax. In the case of a nonresident alien (including a resident alien discontinuing residence), the fact that the alien intends to depart from the United States will justify termination of his taxable period unless the alien establishes to the satisfaction of the district director that he intends to return to the United States and that his departure will not jeopardize collection of the tax. The determination of whether the departure of the alien results in jeopardy will be made on examination of all the facts in the case. Evidence tending to establish that jeopardy does not result from the departure of the alien may be provided, for exam-

ple, by information showing that the alien is engaged in trade or business in the United States or that he leaves sufficient property in the United States to secure payment of his income tax for the taxable year and of any income tax for the preceding year which remains unpaid.

(2) *Alien having no taxable income and resident alien whose taxable period is not terminated.* A statement on Form 2063 shall be filed with the district director by every alien required to obtain a certificate of compliance—

(i) Who is a resident of the United States and whose taxable period is not terminated either because he has had no taxable income for the taxable year up to and including the date of his departure (and for the preceding taxable year where the period for making the income tax return for such year has not expired) or because, although he has had taxable income for such period or periods, the district director has not found that his departure jeopardizes collection of the tax on such income; or

(ii) Who is not a resident of the United States and who has had no taxable income for the taxable year up to and including the date of his departure (and for the preceding taxable year where the period for making the income tax return for such year has not expired).

Any alien described in subdivision (i) or (ii) of this subparagraph who is in default in making return of, or paying, income tax for any taxable year shall, in addition, file with the district director any returns which have not been made as required and pay to the district director the amount of any tax for which he is in default. Upon compliance by an alien with the foregoing requirements of this subparagraph, the district director shall execute and issue to the alien the certificate of compliance attached to Form 2063. The certificate of compliance so issued shall be effective for all departures of the alien during his current taxable year, subject to revocation upon any subsequent departure should the district director have reason to believe that such subsequent departure would result in jeopardy. The statement required of a resident alien under this subparagraph, if made before January 21, 1961, with respect to a departure after January 20, 1961, may be made on a Form 1040C in lieu of a Form 2063.

(3) *Nonresident alien having taxable income and resident alien whose taxable period is terminated*—(i) *Nonresident alien having taxable income.* Every nonresident alien required to obtain a certificate of compliance (but not described in subparagraph (2) of this paragraph) who wishes to establish that his departure does not result in jeopardy shall furnish to the district director such information as may be required for the purpose of determining whether the departure of the alien jeopardizes collection of the income tax and thus requires termination of his taxable period.

(ii) *Nonresident alien whose taxable period is not terminated.* Every nonresident alien described in subdivision (i) of this subparagraph whose taxable period is not terminated upon departure shall file with the district director—

(*a*) A return in duplicate on Form 1040C for the taxable year of his intended departure, showing income received, and reasonably expected to be received, during the entire taxable year within which the departure occurs; and

(*b*) Any income tax returns which have not been filed as required.

Upon compliance by the alien with the foregoing requirements of this subdivision, and the payment of any income tax for which he is in default, the district director shall execute and issue to the alien the certificate of compliance on the duplicate copy of Form 1040C. The certificate of compliance so issued shall be effective for all departures of the alien during his current taxable year, subject to revocation by the district director upon any subsequent departure if the taxable period of the alien is terminated on such subsequent departure.

(iii) *Alien (whether resident or nonresident) whose taxable period is terminated.* Every alien required to obtain a certificate of compliance, whether resident or nonresident, whose taxable period is terminated upon departure shall file with the district director—

(*a*) A return in duplicate on Form 1040C for the short taxable period resulting from such termination, showing income received, and reasonably expected to be received, during the taxable year up to and including the date of departure;

(*b*) Where the period for filing has not expired, the return required under section 6012 and § 1.6012–1 for the preceding taxable year; and

(*c*) Any other income tax returns which have not been filed as required.

Upon compliance with the foregoing requirements of this subdivision, and payment of the income tax required to be shown on the returns filed pursuant to (*a*) and (*b*) of this subdivision and of any income tax due and owing for prior years, the departing alien will be issued the certificate of compliance on the duplicate copy of Form 1040C. The certificate of compliance so issued shall be effective only for the specific departure with respect to which it is issued. A departing alien may postpone payment of the tax required to be shown on the returns filed in accordance with (*a*) and (*b*) of this subdivision until the usual time of payment by furnishing a bond as provided in § 1.6851–3.

(4) *Joint return on Form 1040C.* A departing alien may not file a joint return on Form 1040C unless—

(i) Such alien and his spouse may reasonably be expected to be eligible to file a joint return at the normal close of their taxable periods for which the return is made; and

(ii) If the taxable period of such alien is terminated, the taxable periods of both spouses are so terminated as to end at the same time.

(5) *Annual return.* Notwithstanding that form 1040C has been filed for either the entire taxable year of departure or for a terminated period, the return required under section 6012 and § 1.6012–1 for such taxable year shall be filed. Any income tax paid on income shown on the return on Form 1040C shall be applied against the tax determined to be due on the income required to be shown on the subsequent return under section 6012 and § 1.6012–1.

Because the rules prescribed in this Treasury decision are of a liberalizing character, it is hereby found that it is unnecessary to issue this Treasury decision with notice and public procedure thereon under section 4(a) of the Administrative Procedure Act, approved June 11, 1946, or subject to the effective date limitations of section 4(c) of that Act.

(Sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805)

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 16, 1961.

FRED C. SCRIBNER, Jr.,
Acting Secretary of the Treasury.

[F.R. Doc. 61–514; Filed, Jan. 19, 1961; 8:47 a.m.]

SUBCHAPTER B—ESTATE AND GIFT TAXES

[T.D. 6542]

PART 25—GIFT TAX UNDER CHAPTER 12 OF THE INTERNAL REVENUE CODE OF 1954, AS AMENDED

Miscellaneous Amendments

On December 10, 1960, a notice of proposed rule making was published in the FEDERAL REGISTER (25 F.R. 12707) to conform the Gift Tax Regulations (26 CFR Part 25) to sections 23(f), 30(d), 43(b), 68, and 102(b) of the Technical Amendments Act of 1958 (72 Stat. 1623, 1631, 1641, 1659, 1674) and to section 4(d) of Public Law 86–779 (74 Stat. 1000), and to make a correction of a typographical error in paragraph (f)(4) of § 25.2523(e)–1 of such regulations. After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the regulations as so proposed are hereby adopted.

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 17, 1961.

FRED C. SCRIBNER, Jr.,
Acting Secretary of the Treasury.

In order to conform the Gift Tax Regulations (26 CFR Part 25) to sections 23(f), 30(d), 43(b), 68, and 102(b) of the Technical Amendments Act of 1958 (72 Stat. 1623, 1631, 1641, 1659, 1674) and to section 4(d) of Public Law 86–779 (74 Stat. 1000), and in order to make a correction of a typographical error in paragraph (f)(4) of § 25.2523(e)–1 such regulations are amended as follows:

PARAGRAPH 1. Paragraph (a) of § 25.01 is amended to read as follows:

§ 25.01 Introduction.

(a) *In general.* (1) The regulations in this part are designated "Gift Tax Regulations." These regulations pertain

to (i) the gift tax imposed by chapter 12 of subtitle B of the Internal Revenue Code on the transfer of property by gift by individuals in the calendar year 1955 and subsequent calendar years, and (ii) certain related administrative provisions of subtitle F of the Code. It should be noted that the application of some of the provisions of these regulations may be affected by the provisions of an applicable gift tax convention with a foreign country. Unless otherwise indicated, references in these regulations to the "Internal Revenue Code" or the "Code" are references to the Internal Revenue Code of 1954, as amended, and references to a section or other provision of law are references to a section or other provision of the Internal Revenue Code of 1954, as amended. The Gift Tax Regulations are applicable to the transfer of property by gift by individuals in the calendar year 1955 and subsequent calendar years, and supersede the regulations contained in Part 86, Subchapter B, Chapter I, Title 26, Code of Federal Regulations (1939) (Regulations 108, Gift Tax), as prescribed and made applicable to the Internal Revenue Code of 1954 by Treasury Decision 6091, signed August 16, 1954 (19 F.R. 5167, Aug. 17, 1954).

(2) Section 2501(b) makes the provisions of chapter 12 of the Code apply in the case of gifts made after September 2, 1958, by certain citizens of the United States who were residents of a possession thereof at the time the gifts were made. Section 2501(c) makes the provisions of chapter 12 apply in the case of gifts made after September 14, 1960, by certain other citizens of the United States who were residents of a possession thereof at the time the gifts were made. See paragraphs (c) and (d) of § 25.2501–1. Except as otherwise provided in paragraphs (c) and (d) of § 25.2501–1, the provisions of these regulations do not apply to the making of gifts by such citizens.

PAR. 2. Section 25.2501 is amended to read as follows:

§ 25.2501 Statutory provisions; imposition of tax.

SEC. 2501. *Imposition of tax*—(a) *General rule.* For the calendar year 1955 and each calendar year thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar year by any individual, resident or nonresident, except transfers of intangible property by a nonresident not a citizen of the United States and who was not engaged in business in the United States during such calendar year.

(b) *Certain residents of possessions considered citizens of the United States.* A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "citizen" of the United States within the meaning of that term wherever used in this title unless he acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(c) *Certain residents of possessions considered nonresidents not citizens of the United States.* A donor who is a citizen of the United States and a resident of a possession thereof shall, for purposes of the tax imposed by this chapter, be considered a "nonresident not a citizen of the United States" within the meaning of that term wherever used in this title, but only if such donor acquired his United States citizenship solely by reason of (1) his being a citizen of such possession of the United States, or (2) his birth or residence within such possession of the United States.

(d) *Cross references.* (1) For increase in basis of property acquired by gift for gift tax paid, see section 1015(d).

(2) For exclusion of transfers of property outside the United States by a nonresident who is not a citizen of the United States, see section 2511(a).

[Sec. 2501 as amended by secs. 43(b) and 102(b), Technical Amendments Act 1958 (72 Stat. 1641, 1674) and as amended by sec. 4 (d), Act of Sept. 14, 1960, Pub. Law 86–779 (74 Stat. 1000)]

PAR. 3. Section 25.2501–1 is amended by striking paragraph (b) and inserting in lieu thereof the following paragraphs:

§ 25.2501–1 Imposition of tax.

* * * * *

(b) *Resident.* A resident is an individual who has his domicile in the United States at the time of the gift. For this purpose the United States includes the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to admission as a State. See section 7701(a)(9). All other individuals are nonresidents. A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of moving therefrom. Residence without the requisite intention to remain indefinitely will not constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal.

(c) *Certain residents of possessions considered citizens of the United States.* As used in this part, the term "citizen of the United States" includes a person who makes a gift after September 2, 1958 and who, at the time of making the gift, was domiciled in a possession of the United States and was a United States citizen, and who did not acquire his United States citizenship solely by reason of his being a citizen of such possession or by reason of his birth or residence within such possession. The gift of such a person is, therefore, subject to the tax imposed by section 2501 in the same manner in which a gift made by a resident of the United States is subject to the tax. See paragraph (a) of § 25.01 and paragraph (d) of this section for further information relating to the application of the Federal gift tax to gifts made by persons who were residents of possessions of the United States. The application of this paragraph may be illustrated by the following example and the examples set forth in paragraph (d) of this section:

Example. A, a citizen of the United States by reason of his birth in the United States at San Francisco, established residence in Puerto Rico and acquired Puerto Rican citizenship. A makes a gift of stock of a Spanish corporation on September 4, 1958, while a citizen and domiciliary of Puerto Rico. A's gift is, by reason of the provisions of section 2501(b) subject to the tax imposed by section 2501 inasmuch as his United States citizenship is based on birth in the United States and is not based solely on being a citizen of a possession or solely on birth or residence in a possession.

(d) *Certain residents of possessions considered nonresidents not citizens of the United States.* As used in this part, the term "nonresident not a citizen of the United States" includes a person who makes a gift after September 14, 1960, and who at the time of making the gift, was domiciled in a possession of the United States and was a United States citizen, and who acquired his United States citizenship solely by reason of his being a citizen of such possession or by reason of his birth or residence within such possession. The gift of such a person is, therefore, subject to the tax imposed by section 2501 in the same manner in which a gift is subject to the tax when made by a donor who is a "nonresident not a citizen of the United States." See paragraph (a) of § 25.01 and paragraph (c) of this section for further information relating to the application of the Federal gift tax to gifts made by persons who were residents of possessions of the United States. The application of this paragraph may be illustrated by the following examples and the example set forth in paragraph (c) of this section. In each of the following examples the person who makes the gift is deemed a "nonresident not a citizen of the United States" and his gift is subject to the tax imposed by section 2501 in the same manner in which a gift is subject to the tax when made by a donor who is a nonresident not a citizen of the United States, since he made the gift after September 14, 1960, but would not have been so deemed and subject to such tax if the person who made the gift had made it on or before September 14, 1960.

Example (1). C, who acquired his United States citizenship under section 5 of the Act of March 2, 1917 (39 Stat. 953), by reason of being a citizen of Puerto Rico, while domiciled in Puerto Rico makes a gift on October 1, 1960, of real estate located in New York. C is considered to have acquired his United States citizenship solely by reason of his being a citizen of Puerto Rico.

Example (2). E, whose parents were United States citizens by reason of their birth in Boston, was born in the Virgin Islands on March 1, 1927. On September 30, 1960, while domiciled in the Virgin Islands, he made a gift of tangible personal property situated in Kansas. E is considered to have acquired his United States citizenship solely by reason of his birth in the Virgin Islands (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)).

Example (3). N, who acquired United States citizenship by reason of being a native of the Virgin Islands and a resident thereof on June 28, 1932 (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)), made a gift on October 1, 1960, at which time he was domiciled in the Virgin Islands, of tangible personal property situated in Wisconsin. N is considered to have acquired his United States citizenship solely by reason of his birth or residence in the Virgin Islands.

Example (4). P, a former Danish citizen, who on January 17, 1917, resided in the Virgin Islands, made the declaration to preserve his Danish citizenship required by Article 6 of the treaty entered into on August 4, 1916, between the United States and Denmark. Subsequently P acquired United States citizenship when he renounced

such declaration before a court of record (section 306 of the Immigration and Nationality Act (66 Stat. 237, 8 U.S.C. 1406)). P, while domiciled in the Virgin Islands, made a gift on October 1, 1960, of tangible personal property situated in California. P is considered to have acquired his United States citizenship solely by reason of his birth or residence in the Virgin Islands.

Example (5). R, a former French citizen, acquired his United States citizenship through naturalization proceedings in a court located in the Virgin Islands after having qualified for citizenship by residing in the Virgin Islands for 5 years. R, while domiciled in the Virgin Islands, made a gift of tangible personal property situated in Hawaii on October 1, 1960. R is considered to have acquired his United States citizenship solely by reason of his birth or residence within the Virgin Islands.

PAR. 4. Paragraph (b) of § 25.2511–1 is amended to read as follows:

§ 25.2511–1 Transfers in general.

* * * * *

(b) In the case of a nonresident not a citizen who was not engaged in business in the United States (see § 25.2501–1) during the calendar year, the tax is imposed only if the gift consisted of real estate or tangible personal property situated within the United States at the time of transfer. See §§ 25.2501–1 and 25.2511–3.

PAR. 5. Section 25.2511–3 is amended to read as follows:

§ 25.2511–3 Transfers by nonresidents not citizens.

(a) *In general.* Sections 2511 and 2501 contain provisions relating to the taxation of transfers by a donor who is a nonresident not a citizen of the United States. (See paragraph (b) of § 25.2501–1 for definition of the term "resident".) As combined these rules are—

(1) If the nonresident not a citizen of the United States was not engaged in business in the United States during the calendar year in which the gift was made, the tax applies only to the transfer of real property and tangible personal property situated in the United States.

(2) If the nonresident not a citizen of the United States was engaged in business in the United States during the calendar year in which the gift was made, the tax applies to the transfer of all property (whether real or personal, tangible or intangible) situated in the United States.

(b) *Situs of property.* (1) Real property, tangible personal property, and, except as otherwise provided in subparagraph (2) of this paragraph (relating to shares of stock), the written evidence of intangible personal property which is treated as being the property itself are within the United States if physically situated therein. For example, a bond for the payment of money is not within the United States unless physically situated therein. Intangible personal property the written evidence of which is not treated as being the property itself constitutes property within the United States if consisting of a property right issuing from or enforceable against a resident of the United States or a domestic corporation (public or private) irrespective of where such written evidence is physically located.

(2) Shares of stock owned and held by a nonresident not a citizen of the United States constitute property within the United States if issued by a domestic corporation, irrespective of where the certificates are physically located. However, since a share of stock is intangible property, the transfer by gift by a nonresident not a citizen of the United States of a share of stock issued by a domestic corporation would, under the provisions of paragraph (a) of this section, be subject to the tax only if the donor was engaged in business in the United States during the calendar year in which the gift was made.

(3) Shares of stock owned and held by a nonresident not a citizen of the United States do not constitute property within the United States if issued by a corporation which is not a domestic corporation, irrespective of where the certificates are physically located. Therefore, the tax will not under any circumstances apply to the transfer of a share of such stock oy a nonresident not a citizen of the United States.

PAR. 6. Section 25.2512–6 is amended by adding at the end thereof the following additional example:

§ 25.2512–6 Valuation of certain life insurance and annuity contracts.

* * * * *

Example (5). A donor purchases from a life insurance company for $15,198 a joint and survivor annuity contract which provides for the payment of $60 a month to the donor during his lifetime, and then to his sister for such time as she may survive him. The premium which would have been charged by the company for an annuity of $60 monthly payable during the life of the donor alone is $10,690. The value of the gift is $4,508 ($15,198 less $10,690).

PAR. 7. There is inserted immediately after § 25.2516–2 the following new sections:

§ 25.2517 Statutory provisions; certain annuities under qualified plans.

SEC. 2517. *Certain annuities under qualified plans*—(a) *General rule.* The exercise or nonexercise by an employee of an election or option whereby an annuity or other payment will become payable to any beneficiary at or after the employee's death shall not be considered a transfer for purposes of this chapter if the option or election and annuity or other payment is provided for under—

(1) An employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of such exercise or nonexercise, or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(2) A retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of such exercise or nonexercise, or at the time of termination of the plan if earlier, met the requirements of section 401(a) (3), (4), (5), and (6); or

(3) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 503(b) (1), (2), or (3), and which is exempt from tax under section 501(a).

(b) *Transfers attributable to employee contributions.* If the annuity or other payment referred to in subsection (a) is attributable to any extent to payments or contributions made by the employee, then subsection (a) shall not apply to that part of the value of such annuity or other payment which bears the same proportion to the total value of the annuity or other payment as the total payments or contributions made by the employee bear to the total payments or contributions made. For purposes of the preceding sentence, payments or contributions made by the employee's employer or former employer toward the purchase of an annuity contract described in subsection (a)(3) shall, to the extent not excludable from gross income under section 403(b), be considered to have been made by the employee.

(c) *Employee defined.* For purposes of this section, the term "employee" includes a former employee.

[Sec. 2517 as added by sec. 68 and as amended by sec. 23(f), Technical Amendments Act 1958 (72 Stat. 1659)]

§ 25.2517–1 Employees' annuities.

(a) *In general.* (1) Section 2517 provides an exception to the general rule of section 2511 by exempting from gift tax all or part of the value of certain annuities or other payments for the benefit of employees' surviving beneficiaries. Under the general rule in section 2511, where an employee has an unqualified right to an annuity but takes a lesser annuity with the provision that upon his death a survivor annuity or other payment will be paid to his designated beneficiary, the employee has made a gift to the beneficiary at the time he gives up his power to deprive the beneficiary of the survivor annuity or other payment. See especially § 25.2511–1(h)(10). The making of such a gift by the employee may be accomplished in three principal ways:

(i) By irrevocably electing to take the reduced annuity and designating the individual who is to receive the survivor annuity or other payment. In this case the gift is made at the time the election and designation are irrevocably made.

(ii) By permitting a prior revocable election of a reduced annuity and designation of beneficiary to become irrevocable through failure to revoke during the period during which revocation could be made. In this case the gift is made at the time the prior election and designation become irrevocable.

(iii) By permitting an option to expire under which the employee could, by exercising the option, have defeated the beneficiary's interest in the survivor annuity or other payment, and thereby regain for himself the right to a full annuity. In this case the gift is made at the time the employee permits the option to expire.

The value of the gift is the value, on the date of the gift, of the survivor annuity or other payment, computed in accordance with the principles set forth in §§ 25.2512–1, 25.2512–5, and 25.2512–6. It should be noted that such a gift is a gift of a future interest within the contemplation of § 25.2503–3 and no part thereof may be excluded in determining the total amount of gifts made during the calendar year.

(2) Section 2517 exempts from gift tax all or a portion of the value of the annuities or other payments described in subparagraph (1) of this paragraph which otherwise would be considered as

gifts by employees to their beneficiaries. See paragraph (b) of this section for a complete description of the annuities and other payments to which the exemption applies. Also see paragraph (c) of this section for the portion of the annuity or other payment which is to be excluded in those cases where the annuity or other payment is attributable to payments or contributions made by both the employee and the employer. In the case of an annuity or other payment payable under an employees' trust or under a retirement annuity contract described in paragraph (b)(1) (i) or (ii) of this section, the exemption applies if the gift would otherwise be considered as having been made on or after January 1, 1955. In the case of an annuity or other payment payable under a retirement annuity contract described in paragraph (b)(1)(iii) of this section, the exclusion applies if the gift would otherwise be considered as having been made on or after January 1, 1958.

(b) *Annuities or other payments to which section 2517 applies.* (1) Except to the extent provided otherwise in paragraph (c) of this section, section 2517 exempts from transfers subject to the gift tax the value of an annuity or other payment which, upon the death of an employee, will become payable to the employee's beneficiary under:

(i) An employees' trust (or under a contract purchased by an employees' trust) forming part of a pension, stock bonus or profit-sharing plan which, at the time of such exercise or nonexercise, or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(ii) A retirement annuity contract purchased by an employer (and not by an employees' trust) pursuant to a plan which, at the time of such exercise or non-exercise, or at the time of termination of the plan if earlier, met the requirements of section 401(a) (3), (4), (5), and (6); or

(iii) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 503(b) (1), (2), or (3), and which is exempt from tax under section 501(a).

(2) The term "annuity or other payment" as used in this section, has reference to one or more payments extending over any period of time. The payments may be equal or unequal, conditional or unconditional, periodic or sporadic. For purposes of this section, the term "employee" includes a former employee. The application of this paragraph may be illustrated by the following example:

Example. Pursuant to a pension plan, the employer made contributions to a trust which was to provide each employee, upon his retirement at age 60, with an annuity for life, and which contained a provision for designating either before or after retirement, a surviving beneficiary. No contributions under the plan were made by the employee. At the time of designating the surviving beneficiary (January 20, 1955), the pension trust formed part of a plan meeting the requirements of section 401(a). Assume that an employee made an irrevocable election whereby he would receive a lesser annuity, and after his death, annuity payments would be continued to his wife. Since the wife was designated annuitant under a qualified pension plan, no part of the value of such annuity is includible in the total amount of gifts for the calendar year by reason of the provisions of section 2517.

(c) *Amount excludable from gift.* (1) If an annuity or other payment described in paragraph (a)(1) of this section is attributable to payments or contributions made by both the employee and the employer, the exclusion is limited to that proportion of the value on the date of the gift (see paragraph (a)(1) of this section) of the annuity or other payment which the employer's contribution (or a contribution made on the employer's behalf) to the plan on the employee's account bears to the total contributions to the plan on the employee's account. In applying the ratio set forth in the preceding sentence, payments or contributions made by the employer toward the purchase of an annuity contract described in paragraph (b)(1)(iii) of this section are considered to be contributions made by the employee (and not by the employer) to the extent that such contributions are, or were, not excludable from the employee's gross income under section 403(b). The application of this subparagraph may be illustrated by the following examples:

Example (1). Pursuant to a pension plan, contributions were made by employer and employee to a trust which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which contained a provision for designating either before or after retirement, a surviving beneficiary upon the employee's death. Assume that the employee made an irrevocable election on January 20, 1955, whereby he would receive a lesser annuity and that after his death annuity payments would be continued to his wife. At the time of making the election, the pension trust formed part of a plan meeting the requirements of section 401(a); contributions to the plan on the employee's account amounted to $20,000 of which $15,000 was contributed by the employer and $5,000 was contributed by the employee; and the value of the survivor annuity was $8,000. Since the wife's annuity was receivable under a qualified pension plan, that part of the value of such annuity which is attributable to the employer's contributions $\left(\frac{\$15,000}{\$20,000} \times \$8,000 \text{ or } \$6,000\right)$ is excludable from gifts by reason of the provisions of section 2517(b).

Example (2). An employer purchased a retirement annuity contract for an employee which was to provide the employee, upon his retirement at age 60, with an annuity for life and which in accordance with the employee's irrevocable election, under which he agreed to accept reduced annuity payments, provided that annuity payments would be continued to his wife after his death. At the time of making the election (January 20, 1955), the plan under which the retirement annuity contract was purchased met the requirements of section 401(a) (3), (4), (5), and (6). The retirement annuity contract was purchased from a life insurance company at a cost of $15,198 of which $3,039.60 was contributed by the employee. The premium which would have been charged by the life insurance company for the reduced retirement annuity payments for the life of the employee alone is $10,690. The value, at the time of the election, of the survivor annuity which will become payable to the wife if she survives the employee is $4,508 ($15,198—$10,690). Of such amount, only $901.60 is includible in the employee's gifts, computed as follows:

$$\frac{\$3,039.60 \text{ (employee's contribution)}}{\$15,198.00 \text{ (total contribution)}} \times \$4,508 = \$901.60.$$

Example (3). An employer purchased a retirement annuity contract for an employee which was to provide the employee, upon his retirement at age 60, with an annuity for life and which contained a provision for designating a surviving beneficiary. Assume that the employee made an irrevocable election whereby he would receive a lesser annuity, and after his death, annuity payments would be continued to his wife. At the time of making the election (January 20, 1959), the employer was an organization referred to in section 503(b) (1), (2), or (3) and exempt from tax under section 501(a). As of the date of the election the total contributions toward the cost of the annuity, all by the employer, amounted to $25,000. Of this amount $5,000 was includible in the employee's income under the requirements of section 403(b) and is, therefore, considered as the employee's contributions for the purpose of applying section 2517(b).

(2) In certain cases, the employer's contribution (or a contribution made on his behalf) to a plan on the employee's account and thus the total contributions to the plan on the employee's account cannot be readily ascertained. In order to apply the ratio stated in subparagraph (1) of this paragraph in such a case, the method outlined in the following two sentences must be used unless a more precise method is presented. In such a case, the total contributions to the plan on the employee's account is the value of the annuities or other payments payable to the employee and his beneficiary computed in accordance with the rules set forth in § 25.2512–5. By subtracting from such value the amount of the employee's contribution to the plan, the amount of the employer's contribution to the plan on the employee's account may be obtained. The application of this subparagraph may be illustrated by the following example:

Example. Pursuant to a pension plan, the employer and the employee contributed to a trust which was to provide the employee, upon his retirement at age 60, with an annuity for life, and which contained a provision for designating either before or after retirement, a surviving beneficiary to receive an annuity upon the employee's death. At the time of the employee's retirement on January 20, 1955, he made an irrevocable election designating his wife as beneficiary. Also, at that time, the pension trust formed part of a plan meeting the requirements of section 401(a). Assume the following: (i) That the employer's contributions to the fund were not credited to the accounts of individual employees; (ii) that the value of the employee's annuity and his wife's annuity, computed as of the time of the employee's retirement, was $40,000; (iii) that the employee contributed $10,000 to the plan; and (iv) that the value at the time of the employee's retirement of the wife's annuity was $16,000. On the basis of these facts, the total contributions to the fund on the employee's account are presumed to be $40,000 and the employer's contribution to the plan on the employee's account is presumed to be $30,000 ($40,000 less $10,000). Since the election and the wife's annuity were provided for under a qualified pension

plan, that part of the value of such annuity which is attributable to the employer's contributions ($\frac{\$30,000}{\$40,000} \times \$16,000$, or $12,000) is excludable in determining the total amount of gifts for the calendar year by reason of the provisions of section 2517. Since the wife's right to a deferred annuity is a gift of a future interest the $3,000 exclusion provided in section 2503 is not allowable.

PAR. 8. Section 25.2522(c) is amended to read as follows:

§ 25.2522(c) Statutory provisions; charitable and similar gifts; disallowance of deductions in certain cases.

SEC. 2522. *Charitable and similar gifts.* * * *

(c) *Disallowance of deductions in certain cases.* For disallowance of certain charitable, etc., deductions otherwise allowable under this section, see sections 503 and 681. [Sec. 2522(c) as amended by sec. 30(d), Technical Amendments Act 1958 (72 Stat. 1631)]

PAR. 9. Subparagraph (4) of § 25.2523(e)-1(f) is revised to read as follows:

§ 25.2523(e)-1 Marital deduction; life estate with power of appointment in donee spouse.

* * * * *

(f) *Right to income.* * * *

(4) Provisions granting administrative powers to the trustees will not have the effect of disqualifying an interest transferred in trust unless the grant of powers evidences the intention to deprive the donee spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest transferred in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus, the power to apply the income or corpus for the benefit of the spouse, and the power to retain the assets transferred to the trust. For example, a power to retain trust assets which consist substantially of unproductive property will not disqualify the interest if the applicable rules for the administration of the trust require, or permit the spouse to require, that the trustee either make the property productive or convert it within a reasonable time. Nor will such a power disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets. Further, a power to retain a residence for the spouse or other property for the personal use of the spouse will not disqualify the interest transferred in trust.

(Sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805)

[F.R. Doc. 61-563; Filed, Jan. 19, 1961; 8:52 a.m.]

SUBCHAPTER C—EMPLOYMENT TAXES

[T.D. 6541]

PART 31—EMPLOYMENT TAXES; APPLICABLE ON AND AFTER JANUARY 1, 1955

Miscellaneous Amendments

On December 14, 1960, notice of proposed rule making with respect to regulations under sections 3201, 3202(a), 3211, and 3221 of the Internal Revenue Code of 1954, as amended, relating to taxes imposed by the Railroad Retirement Tax Act (chapter 22 of the Code) was published in the FEDERAL REGISTER (25 F.R. 12835). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the regulations as so proposed are hereby adopted.

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 17, 1961.

FRED C. SCRIBNER, JR.,
Acting Secretary of the Treasury.

In order to conform the Employment Tax Regulations (26 CFR Part 31) to sections 201 and 202 of the Act of May 19, 1959 (Public Law 86-28, 73 Stat. 28, 30), such regulations are amended as follows:

PARAGRAPH 1. Section 31.3201 is amended to read as follows:

§ 31.3201 Statutory provisions; rate of tax.

SEC. 3201. *Rate of tax.* In addition to other taxes, there is hereby imposed on the income of every employee a tax equal to—

(1) 6¾ percent of so much of the compensation paid to such employee for services rendered by him after the month in which this provision was amended in 1959, and before January 1, 1962, and

(2) 7¼ percent of so much of the compensation paid to such employee for services rendered by him after December 31, 1961,

as is not in excess of $400 for any calendar month: *Provided,* That the rate of tax imposed by this section shall be increased, with respect to compensation paid for services after December 31, 1964, by a number of percentage points (including fractional points) equal at any given time to the number of percentage points (including fractional points) by which the rate of the tax imposed with respect to wages by section 3101 at such time exceeds the rate provided by paragraph (2) of such section 3101 as amended by the Social Security Amendments of 1956.

[Sec. 3201 as amended by sec. 206(a), Act of Aug. 31, 1954 (Pub. Law 746, 83d Cong., 68 Stat. 1040); sec. 201(a), Act of May 19, 1959 (Pub. Law 86-28, 73 Stat. 28)]

PAR. 2. Section 31.3201-1 is amended to read as follows:

§ 31.3201-1 Measure of employee tax.

The employee tax with respect to compensation paid after 1954 for services rendered after 1954 is measured by the amount of such compensation paid to an individual for services rendered as an employee to one or more employers, excluding, however, the amount of—

(a) Compensation in excess of $400 which is paid to the employee after May 31, 1959, for services rendered during any one calendar month after May 31, 1959;

(b) Compensation in excess of $350 which is paid to the employee after 1954 and before June 1, 1959, for services rendered during any one calendar month after May 31, 1959; and

(c) Compensation in excess of $350 which is paid to the employee after 1954 for services rendered during any one calendar month after 1954 and before June 1, 1959.

The employee tax with respect to compensation paid after May 31, 1959, for services rendered after such date, is measured without regard to any amount of compensation paid before June 1, 1959, for such services. The employee tax with respect to compensation paid before June 1, 1959, for services rendered after May 31, 1959, is measured without regard to any amount of compensation paid after May 31, 1959, for such services. For provisions relating to compensation, see § 31.3231(e)-1. For provisions relating to the circumstances under which certain compensation is to be disregarded for the purpose of determining the employee tax, see paragraph (a) (4) and (5) of § 31.3231(e)-1.

PAR. 3. Section 31.3201-2 is amended to read as follows:

§ 31.3201-2 Rates and computation of employee tax.

(a) *Rates.* The rates of employee tax applicable with respect to compensation are as follows:

	Percent
Compensation paid at any time after 1954 for services rendered after 1954 and before June 1, 1959; and compensation paid after 1954 and before June 1, 1959, for services rendered after May 31, 1959	6¼
Compensation paid after May 31, 1959, for services rendered after May 31, 1959, and before 1962	6¾
Compensation paid after May 31, 1959, for services rendered during the calendar years 1962, 1963, and 1964	7¼

The rate of employee tax with respect to compensation paid after May 31, 1959, for services rendered after 1964 is the sum of 7¼ percent and an additional percentage. Such additional percentage is determined by subtracting 2¾ percent from the rate of tax imposed by section 3101 with respect to wages received at the time such services are rendered.

Example. If the rate of tax imposed by section 3101 with respect to wages received in 1965 is 3½ percent, then the rate of tax imposed by section 3201 with respect to compensation paid after May 31, 1959, for services rendered in 1965 is 8 percent. (That is, 2¾ percent subtracted from 3½ percent leaves a remainder of ¾ percent. Such remainder of ¾ percent added to 7¼ percent equals 8 percent.)

(b) *Computation.* The employee tax is computed by multiplying the amount of the employee's compensation with respect to which the employee tax is imposed by the rate applicable to such

compensation, as determined under paragraph (a) of this section.

PAR. 4. Section 31.3202 is amended by revising section 3202(a) and the historical note to read as follows:

§ 31.3202 Statutory provisions; deduction of tax from compensation.

Sec. 3202. *Deduction of tax from compensation*—(a) *Requirement.* The tax imposed by section 3201 shall be collected by the employer of the taxpayer by deducting the amount of the tax from the compensation of the employee as and when paid. If an employee is paid compensation after the month in which this provision was amended in 1959, by more than one employer for services rendered during any calendar month after the month in which this provision was amended in 1959 and the aggregate of such compensation is in excess of $400, the tax to be deducted by each employer other than a subordinate unit of a national railway-labor-organization employer from the compensation paid by him to the employee with respect to such month shall be that proportion of the tax with respect to such compensation paid by all such employers which the compensation paid by him after the month in which this provision was amended in 1959, to the employee for services rendered during such month bears to the total compensation paid by all such employers after the month in which this provision was amended in 1959, to such employee for services rendered during such month; and in the event that the compensation so paid by such employers to the employee for services rendered during such month is less than $400, each subordinate unit of a national railway-labor-organization employer shall deduct such proportion of any additional tax as the compensation paid by such employer after the month in which this provision was amended in 1959, to such employee for services rendered during such month bears to the total compensation paid by all such employers after the month in which this provision was amended in 1959, to such employee for services rendered during such month.

* * * * *

[Sec. 3202 as amended by sec. 206(a), Act of Aug. 31, 1959 (Pub. Law 746, 83d Cong., 68 Stat. 1040); sec. 201(b), Act of May 19, 1959 (Pub. Law 86-28, 73 Stat. 29)]

PAR. 5. Section 31.3202-1 is amended by revising paragraph (b), and by adding a new paragraph (f), to read as follows:

§ 31.3202-1 Collection of, and liability for, employee tax.

* * * * *

(b) *Collection; payments by two or more employers in excess of monthly compensation limitation*—(1) *Aggregate monthly compensation in excess of $400 paid after May 31, 1959, for services rendered after that date.* If an employee is paid compensation after May 31, 1959, by two or more employers for services rendered during any one calendar month after such date, and if the aggregate compensation paid to such employee after such date by all employers for services rendered during that month is in excess of $400, the employee tax to be deducted by each employer from the compensation as and when paid by him after May 31, 1959, to the employee shall be determined as follows:

(i) If such compensation is paid by two or more employers, none of whom is a subordinate unit of a national railway-labor-organization employer (see paragraph (a)(6) of § 31.3231(a)-1), each employer shall deduct the employee tax with respect to that proportion of $400 of compensation which the compensation paid after May 31, 1959, by such employer to the employee for the month bears to the total compensation paid after such date to such employee by all employers for that month. See example (1) in subdivision (vii) of this subparagraph.

(ii) If such compensation is paid by two or more employers, each of which is a subordinate unit of a national railway-labor-organization employer, each subordinate unit shall deduct the employee tax with respect to that proportion of $400 of compensation which the compensation paid after May 31, 1959, by such subordinate unit to the employee for the month bears to the total compensation paid after such date to such employee by all such subordinate units for that month.

(iii) If such compensation is paid by two or more employers, only one of whom is an employer other than a subordinate unit of a national railway-labor-organization employer, and if the compensation paid after May 31, 1959, to the employee by the employer other than a subordinate unit equals or exceeds $400 for the month, then no employee tax shall be deducted by any such subordinate unit from the compensation paid by it after such date to such employee for that month, and the employer other than a subordinate unit shall deduct the employee tax with respect to $400 of compensation paid by him after such date to such employee for that month. See example (2) in subdivision (vii) of this subparagraph.

(iv) If such compensation is paid by two or more employers other than a subordinate unit of a national railway-labor-organization employer and by one or more subordinate units of a national railway-labor-organization employer, and if the total compensation paid after May 31, 1959, to the employee by the employers other than a subordinate unit equals or exceeds $400 for the month, then no employee tax shall be deducted by any such subordinate unit from the compensation paid by it after such date to such employee for that month, and each employer other than subordinate unit shall deduct the employee tax with respect to that proportion of $400 of compensation which the compensation paid after such date by such employer to the employee for the month bears to the total compensation paid after such date to such employee by all such employers other than a subordinate unit for that month. See example (3) in subdivision (vii) of this subparagraph.

(v) If such compensation is paid by two or more employers, only one of whom is a subordinate unit of a national railway-labor-organization employer, and if the total compensation paid after May 31, 1959, to the employee by all employers other than the subordinate unit is less than $400 for the month, then each employer other than the subordinate unit shall deduct the employee tax with respect to the full amount of compensation paid by him after such date to such employee for that month, and the subordinate unit of a national railway-labor-organization employer shall deduct the employee tax with respect to the remainder of $400 of compensation less the total compensation paid after such date to such employee for that month by all other employers. See example (4) in subdivision (vii) of this subparagraph.

(vi) If such compensation is paid by one or more employers other than a subordinate unit of a national railway-labor-organization employer and by two or more subordinate units of a national railway-labor-organization employer, and if the total compensation paid after May 31, 1959, to the employee by all employers other than the subordinate units is less than $400 for the month, then each employer other than the subordinate units shall deduct the employee tax with respect to the full amount of compensation paid by him after such date to such employee for that month, and each subordinate unit of a national railway-labor-organization employer shall deduct the employee tax with respect to that proportion of the remainder of $400 of compensation less the total compensation paid after such date to such employee for the month by all employers other than the subordinate units which the compensation paid after such date by such subordinate unit to the employee for that month bears to the total compensation paid after such date to such employee by all such subordinate units for that month. See example (5) in subdivision (vii) of this subparagraph.

(vii) The application of certain of the principles stated in this subparagraph may be illustrated by the following examples:

Example (1). A, an employee, renders services during June 1959 for employers X, Y, and Z, none of whom is a subordinate unit of a national railway-labor-organization employer. For such services A is paid in June 1959 or thereafter compensation of $100 by X, $100 by Y, and $300 by Z, or an aggregate of $500 for the month. In such case X pays one-fifth of A's aggregate compensation for the month, Y pays one-fifth, and Z pays three-fifths. X and Y, therefore, are each required to deduct the employee tax with respect to one-fifth of $400, or $80, and Z is required to deduct the employee tax with respect to three-fifths of $400, or $240.

Example (2). A, an employee, renders services during June 1959 for employer X, an employer other than a subordinate unit of a national railway-labor-organization employer, and for employers Y and Z, each of which is a subordinate unit of a national railway-labor-organization employer. For such services A is paid in the month or thereafter compensation of $400 by X, $50 by Y, and $35 by Z. Since the compensation paid A for the month by X equals $400, neither Y nor Z is required to deduct any employee tax from the compensation paid by him to A for the month; and X is required to deduct the employee tax with respect to the full $400 paid by him to A for the month.

Example (3). A, an employee, renders services during June 1959 for employers W and X, each of whom is an employer other than a subordinate unit of a national railway-labor-organization employer, and for employers Y and Z, each of which is a subordinate unit of a national railway-labor-organization employer. For such services A is paid in the month or thereafter compen-

sation of $200 by W and $300 by X, or an aggregate of $500 for the month, and compensation of $50 by Y and $50 by Z. Since the aggregate compensation paid A for the month by W and X is in excess of $400, neither Y nor Z is required to deduct any employee tax from the compensation paid by him to A for the month. Of the aggregate compensation of $500 paid A for the month by W and X, W pays two-fifths and X pays three-fifths. W, therefore, is required to deduct the employee tax with respect to two-fifths of $400, or $160, and X is required to deduct the employee tax with respect to three-fifths of $400, or $240.

Example (4). A, an employee, renders services during June 1959 for employer X, an employer other than a subordinate unit of a national railway-labor-organization employer, and for employer Y, a subordinate unit of a national railway-labor-organization employer. For such services A is paid in the month or thereafter compensation of $250 by X and $200 by Y. In such case X is required to deduct the employee tax with respect to the full $250 paid by him to A for the month; and Y is required to deduct the employee tax only with respect to $150 ($400 minus $250 paid by X).

Example (5). A, an employee, renders services during June 1959 for employers W and X, each of whom is an employer other than a subordinate unit of a national railway-labor-organization employer, and for employers Y and Z, each of which is a subordinate unit of a national railway-labor-organization employer. For such services A is paid in the month or thereafter compensation of $190 by W, $120 by X, $50 by Y, and $100 by Z. In such case W and X are each required to deduct the employee tax with respect to the full amount paid to A for the month, that is, W with respect to $190 and X with respect to $120; and Y and Z are required to deduct the employee tax with respect to their proportionate share of $90 ($400 minus $310 paid by W and X). Of the aggregate compensation of $150 paid by Y and Z, $50, or one-third, was paid by Y, and $100, or two-thirds, was paid by Z. In such case Y is required to deduct the employee tax with respect to one-third of $90, or $30, and Z is required to deduct the employee tax with respect to two-thirds of $90, or $60.

(2) *Aggregate monthly compensation in excess of $350 paid before June 1, 1959, for services rendered after May 31, 1959.* If an employee is paid compensation within the period January 1, 1955, to May 31, 1959, both dates inclusive, by two or more employers for services rendered during any one calendar month after May 31, 1959, and if the aggregate compensation paid within such period to such employee by all employers for services rendered during such month is in excess of $350, the employee tax to be deducted by each employer from the compensation as and when paid by him to the employee within such period shall be determined in accordance with the principles stated in subparagraph (1) of this paragraph. Such principles should be applied, however, with reference to the compensation and services described in this subparagraph.

(3) *Aggregate monthly compensation in excess of $350 paid after 1954 for services rendered before June 1, 1959.* If an employee is paid compensation at any time after 1954 by two or more employers for services rendered during any one calendar month within the period January 1, 1955, to May 31, 1959, both dates inclusive, and if the aggregate compensation paid after 1954 to such employee by all employers for services rendered during such month is in excess of $350, the employee tax to be deducted by each employer from the compensation as and when paid by him after 1954 to the employee shall be determined in accordance with the principles stated in subparagraph (1) of this paragraph. Such principles should be applied, however, with reference to the compensation and services described in this subparagraph.

* * * * *

(f) *Cross reference.* See paragraph (a) (4) and (5) of § 31.3231(e)–1 for provisions relating to the circumstances under which certain compensation is to be disregarded for the purpose of determining the employee tax.

PAR. 6. Section 31.3211 is amended to read as follows:

§ 31.3211 Statutory provisions; rate of tax.

Sec. 3211. *Rate of tax.* In addition to other taxes, there is hereby imposed on the income of each employee representative a tax equal to—

(1) 13½ percent of so much of the compensation paid to such employee representative for services rendered by him after the month in which this provision was amended in 1959, and before January 1, 1962, and

(2) 14½ percent of so much of the compensation paid to such employee representative for services rendered by him after December 31, 1961,

as is not in excess of $400 for any calendar month: *Provided*, That the rate of tax imposed by this section shall be increased, with respect to compensation paid for services rendered after December 31, 1964, by a number of percentage points (including fractional points) equal at any given time to twice the number of percentage points (including fractional points) by which the rate of the tax imposed with respect to wages by section 3101 at such time exceeds the rate provided by paragraph (2) of such section 3101 as amended by the Social Security Amendments of 1956.

[Sec. 3211 as amended by sec. 206(a), Act of Aug. 31, 1954 (Pub. Law 746, 83d Cong., 68 Stat. 1040); sec. 201(c), Act of May 19, 1959 (Pub. Law 86-28, 73 Stat. 29)]

Par. 7. Section 31.3211–1 is amended to read as follows:

§ 31.3211–1 Measure of employee representative tax.

(a) *General rule.* Except as provided in paragraph (b) of this section the employee representative tax with respect to compensation paid after 1954 for services rendered after 1954 is measured by the amount of such compensation paid to an individual for services rendered as an employee representative, excluding, however, the amount of—

(1) Compensation in excess of $400 which is paid to the employee representative after May 31, 1959, for services rendered during any one calendar month after May 31, 1959;

(2) Compensation in excess of $350 which is paid to the employee representative after 1954 and before June 1, 1959, for services rendered during any one calendar month after May 31, 1959; and

(3) Compensation in excess of $350 which is paid to the employee representative after 1954 for services rendered during any one calendar month after 1954 and before June 1, 1959.

The employee representative tax with respect to compensation paid after May 31, 1959, for services rendered after such date, is measured without regard to any amount of compensation paid before June 1, 1959, for such services. The employee representative tax with respect to compensation paid before June 1, 1959, for services rendered after May 31, 1959, is measured without regard to any amount of compensation paid after May 31, 1959, for such services. For provisions relating to compensation, see § 31.3231(e)–1.

(b) *Aggregate monthly compensation as employee representative and employee in excess of monthly compensation limitation*—(1) *Compensation in excess of $400 paid after May 31, 1959, for services rendered after that date.* (i) If during any one calendar month after May 31, 1959, an individual renders services both as an employee representative and as an employee and the total compensation paid after such date to the individual for services rendered during such month both as an employee representative and as an employee exceeds $400, the measure of the employee representative tax for such month shall be $400 minus the compensation paid after May 31, 1959, to such individual for services rendered by him during such month as an employee.

(ii) The application of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. A renders services as an employee representative during June 1959 for which he is paid $100 in June 1959 or thereafter. During such month A also renders services as an employee for one or more employers and receives during such month or thereafter compensation of $350. Inasmuch as the total amount of compensation paid after May 31, 1959, to A for services rendered during June 1959 as an employee representative and as an employee exceeds $400 ($100 plus $350, or $450), the measure of the employee representative tax is $400 minus $350 (A's compensation for services rendered as an employee), or $50.

(2) *Compensation in excess of $350 paid before June 1, 1959, for services rendered after May 31, 1959.* If during any one calendar month after May 31, 1959, an individual renders services as an employee representative and as an employee and the total compensation paid after 1954 and before June 1, 1959, to the individual for services rendered during such month as an employee representative and as an employee exceeds $350, the measure of the employee representative tax for such month shall be $350 minus the compensation paid after 1954 and before June 1, 1959, to such individual for services rendered by him during such month as an employee.

(3) *Compensation in excess of $350 paid after 1954 for services rendered after 1954 and before June 1, 1959.* If during any one calendar month after 1954 and before June 1, 1959, an individual renders services as an employee representative and as an employee and the total compensation paid at any time after 1954 to the individual for services rendered during such month as an employee representative and as an employee

exceeds $350, the measure of the employee representative tax for such month shall be $350 minus the compensation paid at any time after 1954 to such individual for services rendered by him during the month as an employee.

PAR. 8. Section 31.3211–2 is amended to read as follows:

§ 31.3211–2 Rates and computation of employee representative tax.

(a) *Rates.* The rates of employee representative tax applicable with respect to compensation are as follows:

	Percent
Compensation paid at any time after 1954 for services rendered after 1954 and before June 1, 1959; and compensation paid after 1954 and before June 1, 1959, for services rendered after May 31, 1959	12½
Compensation paid after May 31, 1959, for services rendered after May 31, 1959, and before 1962	13½
Compensation paid after May 31, 1959, for services rendered during the calendar years 1962, 1963, and 1964	14½

The rate of employee representative tax with respect to compensation paid after May 31, 1959, for services rendered after 1964 is the sum of 14½ percent and an additional percentage. Such additional percentage is determined by subtracting 2¾ percent from the rate of tax imposed by section 3101 with respect to wages received at the time such services are rendered, and by doubling the remainder.

Example. If the rate of tax imposed by section 3101 with respect to wages received in 1965 is 3½ percent, then the rate of tax imposed by section 3211 with respect to compensation paid after May 31, 1959, for services rendered in 1965 is 16 percent. (That is, 2¾ percent subtracted from 3½ percent leaves a remainder of ¾ percent. Such remainder doubled is 1½ percent. The sum of 1½ percent and 14½ percent is 16 percent.)

(b) *Computation.* The employee representative tax is computed by multiplying the amount of the employee representative's compensation with respect to which the employee representative tax is imposed by the rate applicable to such compensation, as determined under paragraph (a) of this section.

PAR. 9. Section 31.3221 is amended to read as follows:

§ 31.3221 Statutory provisions; rate of tax.

SEC. 3221. *Rate of tax.* (a) In addition to other taxes, there is hereby imposed on every employer an excise tax, with respect to having individuals in his employ, equal to—

(1) 6¾ percent of so much of the compensation paid by such employer for services rendered to him after the month in which this provision was amended in 1959, and before January 1, 1962, and

(2) 7¼ percent of so much of the compensation paid by such employer for services rendered to him after December 31, 1961,

as is, with respect to any employee for any calendar month, not in excess of $400; except that if an employee is paid compensation after the month in which this provision was amended in 1959, by more than one employer for services rendered during any calendar month after the month in which this provision was amended in 1959, the tax imposed by this section shall apply to not more than $400 of the aggregate compensation paid to such employee by all such employers after the month in which this provision was amended in 1959, for services rendered during such month, and each employer other than a subordinate unit of a national railway-labor-organization employer shall be liable for that proportion of the tax with respect to such compensation paid by all such employers which the compensation paid by him after the month in which this provision was amended in 1959, to the employee for services rendered during such month bears to the total compensation paid by all such employers after the month in which this provision was amended in 1959, to such employee for services rendered during such month; and in the event that the compensation so paid by such employers to the employee for services rendered during such month is less than $400, each subordinate unit of a national railway-labor-organization employer shall be liable for such proportion of any additional tax as the compensation paid by such employer after the month in which this provision was amended in 1959, to such employee for services rendered during such month bears to the total compensation paid by all such employers after the month in which this provision was amended in 1959, to such employee for services rendered during such month.

(b) The rate of tax imposed by subsection (a) shall be increased, with respect to compensation paid for services rendered after December 31, 1964, by a number of percentage points (including fractional points) equal at any given time to the number of percentage points (including fractional points) by which the rate of the tax imposed with respect to wages by section 3111 at such time exceeds the rate provided by paragraph (2) of such section 3111 as amended by the Social Security Amendments of 1956.

[Sec. 3221 as amended by sec. 206(a), Act of Aug. 31, 1954 (Pub. Law 746, 83d Cong., 68 Stat. 1040); sec. 201(d), Act of May 19, 1959 (Pub. Law 86–28, 73 Stat. 29)]

PAR. 10. Section 31.3221–1 is amended by revising paragraphs (a) and (b), and by adding a new paragraph (d), as follows:

§ 31.3221–1 Measure of employer tax.

(a) *General rule.* Except as provided in paragraph (b) of this section, the employer tax with respect to compensation paid after 1954 for services rendered after 1954 is measured by the amount of such compensation paid by an employer to his employees, excluding, however, the amount of—

(1) Compensation in excess of $400 which is paid to any employee after May 31, 1959, for services rendered during any one calendar month after May 31, 1959;

(2) Compensation in excess of $350 which is paid to any employee after 1954 and before June 1, 1959, for services rendered during any one calendar month after May 31, 1959; and

(3) Compensation in excess of $350 which is paid to any employee after 1954 for services rendered during any one calendar month after 1954 and before June 1, 1959.

The employer tax with respect to compensation paid after May 31, 1959, for services rendered after such date, is measured without regard to any amount of compensation paid before June 1, 1959, for such services. The employer tax with respect to compensation paid before June 1, 1959, for services rendered after May 31, 1959, is measured without regard to any amount of compensation paid after May 31, 1959, for such services. For provisions relating to compensation, see § 31.3231(e)–1. For provisions relating to the circumstances under which certain compensation is to be disregarded for the purpose of determining the employer tax, see paragraph (a) (4) and (5) of § 31.3231(e)–1.

(b) *Payments by two or more employers in excess of monthly compensation limitation—(1) Aggregate monthly compensation in excess of $400 paid after May 31, 1959, for services rendered after that date.* If an employee is paid compensation after May 31, 1959, by two or more employers for services rendered during any one calendar month after such date, and if the aggregate compensation paid to such employee after such date by all employers for services rendered during such month is in excess of $400, the measure of the employer tax of each employer with respect to the compensation paid by him after such date to the employee for the month shall be determined as follows:

(i) If such compensation is paid by two or more employers, none of whom is a subordinate unit of a national railway-labor-organization employer (see paragraph (a)(6) of § 31.3231(a)–1), the measure of the employer tax of each employer shall be that proportion of $400 which the compensation paid after May 31, 1959, by such employer to the employee for the month bears to the total compensation paid after such date to such employee by all employers for that month.

(ii) If such compensation is paid by two or more employers, each of which is a subordinate unit of a national railway-labor-organization employer, the measure of the employer tax of each subordinate unit shall be that proportion of $400 which the compensation paid after May 31, 1959, by such subordinate unit to the employee for the month bears to the total compensation paid after such date to such employee by all such subordinate units for that month.

(iii) If such compensation is paid by two or more employers, only one of whom is an employer other than a subordinate unit of a national railway-labor-organization employer, and if the compensation paid after May 31, 1959, to the employee by the employer other than a subordinate unit equals or exceeds $400 for the month, then no subordinate unit shall be liable for any employer tax with respect to the compensation paid by it after such date to such employee for that month, and the measure of the employer tax of the employer other than a subordinate unit with respect to the compensation paid by him after 1954 to such employee for that month shall be $400.

(iv) If such compensation is paid by two or more employers other than a subordinate unit of a national railway-labor-organization employer and by one or more subordinate units of a national railway-labor-organization employer, and if the total compensation paid after May 31, 1959, to the employee by the employers other than a subordinate unit equals or exceeds $400 for the month, then no subordinate unit shall be liable for any employer tax with respect to the compensation paid by it after such

date to such employee for that month, and the measure of the employer tax of each employer other than a subordinate unit shall be that proportion of $400 which the compensation paid after such date by such employer to the employee for the month bears to the total compensation paid after such date to such employee by all such employers other than a subordinate unit for that month.

(v) If such compensation is paid by two or more employers, only one of whom is a subordinate unit of a national railway-labor-organization employer, and if the total compensation paid after May 31, 1959, to the employee by all employers other than the subordinate unit is less than $400 for the month, then the measure of the employer tax of each employer other than the subordinate unit shall be the full amount of compensation paid by him after such date to such employee for that month, and the measure of the employer tax of the subordinate unit of a national railway-labor-organization employer shall be the remainder of $400 less the total compensation paid after such date to such employee for that month by all other employers.

(vi) If such compensation is paid by one or more employers other than a subordinate unit of a national railway-labor-organization employer, and by two or more subordinate units of a national railway-labor-organization employer, and if the total compensation paid after May 31, 1959, to the employee by all employers other than the subordinate units is less than $400 for the month, then the measure of the employer tax of each employer other than the subordinate units shall be the full amount of compensation paid by him after such date to such employee for that month, and the measure of the employer tax of each subordinate unit of a national railway-labor-organization employer shall be that proportion of the remainder of $400 less the total compensation paid after such date to such employee for the month by all employers other than the subordinate units which the compensation paid after such date by such subordinate unit to the employee for that month bears to the total compensation paid after such date to such employee by all such subordinate units for that month.

(vii) For illustrations of the application of certain of the principles in this subparagraph, see the examples, illustrating the analogous principles with respect to the deduction of employee tax, set forth in paragraph (b)(1)(vii) of § 31.3202–1.

(2) *Aggregate monthly compensation in excess of $350 paid before June 1, 1959, for services rendered after May 31, 1959.* If an employee is paid compensation within the period January 1, 1955, to May 31, 1959, both dates inclusive, by two or more employers for services rendered during any one calendar month after May 31, 1959, and if the aggregate compensation paid within such period to such employee by all employers for services rendered during such month is in excess of $350, the measure of the employer tax of each employer with respect to the compensation paid by him to the employee within such period shall be determined in accordance with the principles stated in subparagraph (1) of this paragraph. Such principles should be applied, however, with reference to the compensation and services described in this subparagraph.

(3) *Aggregate monthly compensation in excess of $350 paid after 1954 for services rendered before June 1, 1959.* If an employee is paid compensation at any time after 1954 by two or more employers for services rendered during any one calendar month within the period January 1, 1955, to May 31, 1959, both dates inclusive, and if the aggregate compensation paid after 1954 to such employee by all employers for services rendered during such month is in excess of $350, the measure of the employer tax of each employer with respect to the compensation paid by him to the employee after 1954 shall be determined in accordance with the principles stated in subparagraph (1) of this paragraph. Such principles should be applied, however, with reference to the compensation and services described in this subparagraph.

* * * * *

(d) *Cross reference.* See paragraph (a) (4) and (5) of § 31.3231(e)–1 for provisions relating to the circumstances under which certain compensation is to be disregarded for the purpose of determining the employer tax.

PAR. 11. Section 31.3221–2 is amended to read as follows:

§ 31.3221–2 Rates and computation of employer tax.

(a) *Rates.* The rates of employer tax applicable with respect to compensation are as follows:

	Percent
Compensation paid at any time after 1954 for services rendered after 1954 and before June 1, 1959; and compensation paid after 1954 and before June 1, 1959, for services rendered after May 31, 1959	6¼
Compensation paid after May 31, 1959, for services rendered after May 31, 1959, and before 1962	6¾
Compensation paid after May 31, 1959, for services rendered during the calendar years 1962, 1963, and 1964	7¼

The rate of employer tax with respect to compensation paid after May 31, 1959, for services rendered after 1964 is the sum of 7¼ percent and an additional percentage. Such additional percentage is determined by subtracting 2¾ percent from the rate of tax imposed by section 3111 with respect to wages paid at the time such services are rendered.

Example. If the rate of tax imposed by section 3111 with respect to wages paid in 1965 is 3½ percent, then the rate of tax imposed by section 3221 with respect to compensation paid after May 31, 1959, for services rendered in 1965 is 8 percent. (That is, 2¾ percent subtracted from 3½ percent leaves a remainder of ¾ percent. Such remainder of ¾ percent added to 7¼ percent equals 8 percent.)

(b) *Computation.* The employer tax is computed by multiplying the amount of the compensation with respect to which the employer tax is imposed by the rate applicable to such compensation, as determined under paragraph (a) of this section.

(Sec. 7805 of the Internal Revenue Code of 1954; 68 Stat. 917; 26 U.S.C. 7805)

[F.R. Doc. 61–562; Filed, Jan. 19, 1961; 8:52 a.m.]

[T.D. 6538]

SUBCHAPTER D—MISCELLANEOUS EXCISE TAXES

PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES

Laminated Tires

On December 2, 1960, notice of proposed rule making with respect to regulations under section 4071(a)(5) of the Internal Revenue Code of 1954, as amended, relating to the manufacturers excise tax on the sale of laminated tires, was published in the FEDERAL REGISTER (25 F.R. 12362). No objection to the rules proposed having been received during the 30-day period prescribed in the notice, the regulations as so proposed are hereby adopted.

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 16, 1961.

FRED C. SCRIBNER, Jr.,
Acting Secretary of the Treasury.

In order to conform the Manufacturers and Retailers Excise Tax Regulations (26 CFR Part 48) to the Act of April 22, 1960 (Public Law 86–440, 74 Stat. 80), such regulations are amended as follows:

PARAGRAPH 1. Section 48.4071 is amended to read as follows:

§ 48.4071 Statutory provisions; imposition of tax.

SEC. 4071 *Imposition of tax*—(a) *Imposition and rate of tax.* There is hereby imposed upon the following articles, if wholly or in part of rubber, sold by the manufacturer, producer, or importer, a tax at the following rates:

(1) Tires of the type used on highway vehicles, 8 cents a pound.

(2) Other tires (other than laminated tires to which paragraph (5) applies), 5 cents a pound.

(3) Inner tubes for tires, 9 cents a pound.

(4) Tread rubber, 3 cents a pound.

(5) Laminated tires (not of the type used on highway vehicles) which consist wholly of scrap rubber from used tire casings with an internal metal fastening agent, 1 cent a pound.

(b) *Determination of weight.* For purposes of this section, weight shall be based on total weight, except that in the case of tires such total weight shall be exclusive of metal rims or rim bases. Total weight of the articles shall be determined under regulations prescribed by the Secretary or his delegate.

(c) *Rate reduction.* On and after July 1, 1972—

(1) The tax imposed by paragraph (1) of subsection (a) shall be 5 cents a pound; and

(2) Paragraph (4) of subsection (a) shall not apply.

[Sec. 4071 as amended and in effect Jan. 1, 1959, and as further amended by Act of Apr. 22, 1960 (Pub. Law 86–440, 74 Stat. 80)]

PAR. 2. Paragraph (b)(1) of § 48.4071–1 is amended to read as follows:

§ 48.4071–1 **Imposition and rates of tax.**

* * * * *

(b) *Rates and computation of tax*—(1) *Rates of tax.* Tax is imposed upon each of the above-mentioned taxable articles at the rate applicable on the date on which the article is sold, as specified below:

	Cents per pound
(i) *Tires:*	
(a) Of the type used on highway vehicles;	
(1) For the period January 1, 1959, to June 30, 1972, inclusive	8
(2) On or after July 1, 1972	5
(b) Of the type used on other than highway vehicles (excluding laminated tires)	5
(c) Laminated tires:	
(1) For the period January 1, 1959, to May 31, 1960, inclusive	5
(2) On or after June 1, 1960	1
(ii) *Inner tubes*	9
(iii) *Tread rubber:*	
For the period January 1, 1959, to June 30, 1972, inclusive	3

For definitions of the terms "tires of the type used on highway vehicles" and "laminated tires", see paragraphs (c) and (f) of § 48.4072–1.

PAR. 3. Section 48.4072–1 is amended by striking paragraph (f) and inserting the following:

§ 48.4072–1 **Definitions.**

* * * * *

(f) *Laminated tires.* The term "laminated tires", for purposes of the tax imposed by section 4071, means tires (1) which are not "tires of the type used on highway vehicles" within the meaning of paragraph (c) of this section, and (2) which consist wholly of scrap rubber from used tire casings with an internal metal fastening agent.

(g) *Cross references.* For other definitions, see §§ 48.0–2 and 48.7701.

(Sec. 7805 of the Internal Revenue Code of 1954; 68A Stat. 917; 26 U.S.C. 7805)

[F.R. Doc. 61–515; Filed, Jan. 19, 1961; 8:47 a.m.]

[T.D. 6536]

PART 49—FACILITIES AND SERVICES EXCISE TAXES

Excise Tax on Club Dues

On September 23, 1960, a notice of proposed rule making with respect to the Facilities and Services Excise Tax Regulations (26 CFR Part 49) under sections 4241, 4242, and 4243 of the Internal Revenue Code of 1954, as amended, relating to the excise tax on club dues, was published in the FEDERAL REGISTER (25 F.R. 9143). After consideration of all such relevant matter as was presented by interested persons regarding the rules proposed, the regulations as so published are hereby adopted, subject to the changes set forth below. Such regulations supersede § 148.1–2 of the Regulations on Certain Excise Tax Matters under Excise Tax Technical Changes Act of 1958 (26 CFR 148.1–2).

PARAGRAPH 1. Subparagraphs (1), (2), and (3) of paragraph (c), and paragraph (g)(2) of § 49.4241–1 are revised.

PAR. 2. Section 49.4243–1 is revised.

PAR. 3. Paragraphs (a), (b), and (c), and examples (5) and (6) of paragraph (d), of § 49.4243–2 are revised.

PAR. 4. Section 49.4243–3 is revised by changing paragraph (a) and by adding subparagraph (3) to paragraph (b).

[SEAL] DANA LATHAM,
Commissioner of Internal Revenue.

Approved: January 16, 1961.

FRED C. SCRIBNER, Jr.,
Acting Secretary of the Treasury.

The regulations so adopted under sections 4241, 4242, and 4243 of the Internal Revenue Code of 1954, as amended, relating to the excise tax on club dues, read as follows:

Subpart B—Admissions and Dues

CLUB DUES

Sec.	
49.4241	Statutory provisions; imposition of tax.
49.4241–1	Tax on club dues, initiation fees, and life memberships.
49.4242	Statutory provisions; definitions.
49.4242–1	Definition; dues or membership fees.
49.4242–2	Definition; initiation fees.
49.4243	Statutory provisions; exemptions.
49.4243–1	Exemption; fraternal organizations.
49.4243–2	Exemption; assessments for capital improvements.
49.4243–3	Exemption; nonprofit swimming or skating facilities.

AUTHORITY: §§ 49.4241 to 49.4243–3 issued under sec. 7805, I.R.C. 1954; 68A Stat. 917; 26 U.S.C. 7805.

§ 49.4241 Statutory provisions; imposition of tax.

SEC. 4241. *Imposition of tax*—(a) *Rate.* There is hereby imposed—

(1) *Dues or membership fees.* A tax equivalent to 20 percent of any amount paid as dues or membership fees to any social, athletic, or sporting club or organization, if the dues or fees of an active resident annual member are in excess of $10 per year.

(2) *Initiation fees.* A tax equivalent to 20 percent of any amount paid as initiation fees to such a club or organization, if such fees amount to more than $10, or if the dues or membership fees, not including initiation fees, of an active resident annual member are in excess of $10 per year.

(3) *Life memberships.* In the case of life memberships—

(A) A tax equivalent to the tax upon the amount paid as dues or membership fees by members (other than life members) having privileges most nearly comparable to those of the person holding the life membership; or

(B) At the election (made at such time not later than the day on which the first amount is paid for life membership, and made in such manner and form, as the Secretary or his delegate shall by regulations prescribe) of the person holding the life membership, a tax equivalent to 20 percent of any amount paid for the life membership. Any election under this subparagraph shall be irrevocable.

If subparagraph (A) applies, no tax shall be paid under this subsection on amounts paid for the life membership, and the tax under subparagraph (A) shall be paid at the time for the payment of dues or membership fees by members (other than life members) having privileges most nearly comparable to those of the person holding the life membership. Any tax payable under this paragraph shall be in addition to any tax payable under paragraph (1) or (2). No tax shall be payable under this paragraph on any life membership for which no charge is made to any person.

(b) *By whom paid.* Except as provided in section 4243(b), the taxes imposed by this section shall be paid by the person paying such dues or fees, or holding such life membership.

[Sec. 4241 as amended and in effect Jan. 1, 1959, and as further amended by sec. 3(b), Act of Sept. 21, 1959 (Pub. Law 86–344, 73 Stat. 618)]

§ 49.4241–1 Tax on club dues, initiation fees, and life memberships.

(a) *Dues or membership fees.* Section 4241(a)(1) imposes a tax at the rate of 20 percent on amounts paid as dues or membership fees to a social, athletic, or sporting club or organization, if the dues and membership fees of an active resident annual member are in excess of $10 per year. If the dues and membership fees of an active resident annual member of such a club or organization are in excess of $10 per year, the tax applies not only to the dues and membership fees of an active resident annual member, but also to the dues and membership fees of all other members of the club or organization, whether or not the dues and membership fees of the other members are in excess of $10 per year. For definition of the term "dues or membership fees", see paragraph (a) of § 49.4242–1.

(b) *Initiation fees.* Section 4241(a)(2) imposes a tax at the rate of 20 percent on amounts paid as initiation fees required as a condition precedent to membership in a social, athletic, or sporting club or organization, if (1) such initiation fees are in excess of $10, or (2) the dues and membership fees of an active resident annual member are in excess of $10 per year. If the initiation fee exceeds $10, it is subject to the tax, regardless of the amount of dues and membership fees paid by an active resident annual member. If the dues and membership fees paid by an active resident annual member are in excess of $10 per year, any initiation fee, regardless of the amount, is subject to the tax. For definition of the term "initiation fees", see § 49.4242–2.

(c) *Life memberships*—(1) *General rule.* Section 4241(a)(3) imposes a tax on life memberships in a social, athletic, or sporting club or organization. In the absence of an election by the life member to have the tax determined in the manner described in subparagraph (2) of this paragraph, the tax in respect of a life membership is, pursuant to section 4241(a)(3)(A), equivalent to the tax imposed by section 4241(a)(1) (after application of any exemption provided in section 4243 (see particularly paragraph (b) of § 49.4243–2)) upon the amount paid to the club or organization as the dues or membership fees of any member (other than a life member) for privileges most nearly comparable to those enjoyed under the life membership. Thus, if the life membership confers limited privileges comparable to the privileges of certain other members who pay dues in a lesser amount than members having full privileges, the tax in respect of the life membership shall be computed on the basis of such lesser amount. The tax on life memberships imposed by section