Income of $45,000, computed by adding taxable investment income (0) and 50 percent ($22,500) of the amount ($90,000) by which the gain from operations ($90,000) exceeds the taxable investment income (0).

Example 4. For the taxable year 1961, Z, a life insurance company, has taxable investment income of $100,000, a policyholders surplus account of $50,000 as of the beginning of such taxable year, a loss from operations (as defined in section 809(b)(2)) of $25,000, and subtractions from the policyholders surplus account in the amount of $20,000. For the taxable year 1961, Z has life insurance company taxable income of $20,000, as only the amount ($20,000) subtracted from the policyholders surplus account is taken into account.


(a) Transitional rule. Section 802(a)(3) provides a transitional rule for the determination of the tax liability of a life insurance company for the taxable years 1959 and 1960 by reason of the operation of section 802(b)(3). Except as limited by section 802(a)(3) and paragraph (b) of this section, any increase in a life insurance company’s tax that is attributable to the operation of section 802(b)(3) is taken into account only to the extent of one-third and two-thirds for the taxable years 1959 and 1960, respectively. To the extent there is an increase in a life insurance company’s tax that is attributable to the operation of section 802(b)(3) which is not taken into account for the taxable years 1959 and 1960 because of the transitional rule provided by section 802(a)(3) and this paragraph, such amounts shall be included in “other accounts” under section 815(a)(3). For taxable years commencing after December 31, 1960, the full amount of any increase in tax due to the operation of section 802(b)(3) shall be imposed without any further transitional reduction.

(b) Limitations. The transitional rule provided by section 802(a)(3) is limited solely to an increase in tax under section 802(b)(3) that is occasioned by the operation of section 815(c)(3) (relating to subtractions from the policyholders surplus account by reason of distributions to shareholders). This rule is further limited to actual distributions that are made by life insurance companies in 1959 or 1960 and does not extend to other distributions that are treated under section 815(d)(2)(B) as made by life insurance companies in 1959 or 1960. Furthermore, section 802(a)(3) shall not apply to any increase in tax under section 802(b)(3) that is attributable to other subtractions from the policyholders surplus account by reason of the operation of the special rules contained in section 815(d). However, the transitional rule provided by section 802(a)(3) does apply in the case of a distribution to which section 815(e)(1)(B) (1) applies.

(c) Illustration of principles. The provisions of section 802(a)(3) and this section may be illustrated by the following example:

Example. For the taxable year 1960, X, a life insurance company, had taxable investment income of $9,000, gain from operations of $27,000, and subtractions from the policyholders surplus account of $22,000. Based upon these figures, X had life insurance company taxable income of $40,000 for 1960, of which $18,000 was includable under section 802(b)(1) and (2) and $22,000 under section 802(b)(3). Applying the tax imposed by section 802(a)(1) (at rates as in effect for 1960), without regard to the transitional rule of section 802(a)(3), X would have a tax liability of $15,300 ($40,000 multiplied by 52 percent, less $5,500). However, applying the transitional rule of section 802(a)(3), the actual tax liability of X, for 1960, would be $12,000, computed as follows:

| (1) | Total tax liability (without regard to sec. 802(a)(3)) | $15,300 |
| (2) | Life insurance company taxable income | $40,000 |
| (3) | Amount subtracted from policyholders surplus account | $22,000 |
| (4) | Item (2) less item (3) | $18,000 |
| (5) | Tax on amount includible under sec. 802(b) (1) and (2) (30% of $18,000) | $5,400 |
| (6) | Tax attributable to sec. 802(b)(3) item (1) less item (5) | $9,900 |
| (7) | Less: 33 1/3 percent of tax attributable to sec. 802(b)(3) (1/3 of $9,900) | $3,300 |
| (8) | Tax liability for 1960 after application of sec. 802(a)(3) (item (1) less item (7)) | $12,000 |


§ 1.803–1 Life insurance reserves.

(a) The term “life insurance reserves” is defined in section 803(b). Generally, such reserves, as in the case of level premium life insurance, are held to supplement the future premium receipts when the latter, alone, are insufficient to cover the increased risk in the later years. In the case of
cancellable health and accident poli-
cies and similar cancellable contracts,
the unearned premiums held to cover
the risk for the unexpired period cov-
ered by the premiums are not included
in life insurance reserves. Unpaid loss
reserves for noncancellable health and
accident policies are included in life in-
surance reserves if they are computed
or estimated on the basis of recognized
mortality or morbidity tables and as-
sumed rates of interest.

(b) In the case of an assessment life
insurance company or association, life
insurance reserves include sums actu-
ally deposited by such company or as-
sociation with State or Territorial offi-
cers pursuant to law as guaranty or re-
serve funds, and any funds maintained
under the charter or articles of incor-
poration or association of such com-
pany or association, or bylaws (ap-
proved by the State insurance commis-
sioner) of such company or association,
exclusively for the payment of claims
arising under certificates of member-
ship or policies issued upon the assess-
ment plan and not subject to any other
use.

(c) Life insurance reserves, except as
otherwise provided in section 803(b),
must be required by law either by ex-
press statutory provisions or by rules
and regulations of the insurance de-
partment of a State, Territory, or the
District of Columbia when promulgated
in the exercise of a power conferred by
statute but such requirement, without
more, is not conclusive; for example,
life insurance reserves do not include
reserves required to be maintained to
provide for the ordinary running ex-
penses of a business which must be cur-
rently paid by every company from its
income if its business is to continue,
such as taxes, salaries, and unpaid bro-
kerage; nor do they include the net
value of risks reinsured in other sol-
vent companies; liability for premiums
paid in advance; liability for annual
and deferred dividends declared or ap-
portioned; liability for dividends left
on deposit at interest; liability for ac-
crued but unsettled policy claims
whether known or unreported; liability
for supplementary contracts not in-
volving, at the time with respect to
which the liability is computed, life,
health, or accident contingencies.

(d) In any case where reserves are
claimed, sufficient information must
be filed with the return to enable the
district director to determine the va-
lidity of the claim. Only reserves which
are required by law or insurance de-
partment ruling, which are peculiar to
insurance companies, and which are de-
pendent upon interest earnings for
their maintenance will, except as oth-
erwise specifically provided in section
803(b), be considered as life insurance
reserves. A company is permitted to
make use of the highest aggregate re-
serve required by any State or Terri-
tory or the District of Columbia in
which it transacts business, but the re-
serve must have been actually held.

(e) In the case of life insurance com-
panies issuing policies covering life,
health, and accident insurance com-
bined in one policy issued on the week-
ly premium payment plan, continuing
for life and not subject to cancellation,
it is required that reserve funds there-
on be based upon recognized mortality
or morbidity tables covering disability
benefits of the kind contained in poli-
cies issued by this particular class of
companies but they need not be re-
quired by law.

§ 1.803–2 Adjusted reserves.

For the purpose of determining “re-
quired interest” for taxable years be-
ginning after December 31, 1953, but be-
fore January 1, 1955, and ending after
August 16, 1954, certain reserves com-
puted on a preliminary term method
are to be adjusted by increasing such
reserves by 7 percent. The reserves to
be thus adjusted are reserves computed
on preliminary term methods, such as
the Illinois Standard, or the Select and
Ultimate methods. Only reserves on
policies in the modification period are
to be so adjusted. Where reserves under
a preliminary term method are the
same as on the level premium method,
and in the case of reserves for extended
or paid-up insurance, no adjustment is
to be made. The reserves are thus ad-
justed, and the rate of interest on
which they are computed, should be re-
ported in Schedule A, Form 1120L.

§ 1.803–3 Interest paid or accrued.

Interest paid or accrued is one of the
elements to be used in computing the