

were paid during the year 1958 but such items would have been properly taken into account for the year 1957 if the taxpayer had been on the accrual method for the year 1957, then the taxpayer will not be permitted to deduct such expense items for the year 1958. For a special transitional rule applicable with respect to changes in method of accounting required by section 818(a) and paragraph (a) of this section, see section 818(e) and § 1.818-6.

(c) *Change of basis in computing reserves.* (1) Section 806(b) provides that if the basis for determining the amount of any item referred to in section 810(c) as of the close of the taxable year differs from the basis for such determination as of the beginning of the taxable year, then for purposes of subpart B, part I, subchapter L, chapter 1 of the Code (relating to the determination of taxable investment income), the amount of such item shall be the amount computed on the old basis as of the close of the taxable year and the amount computed on the new basis as of the beginning of the next taxable year. Similarly, section 810(d)(1) provides rules for determining the amount of the adjustment to be made for purposes of subpart C, part I, subchapter L, chapter 1 of the Code (relating to the determination of gain or loss from operations), if the basis for determining any item referred to in section 810(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. Under an accrual method of accounting, a change in the basis or method of computing the amount of liability of any item referred to in section 810(c) occurs in the taxable year in which all the events have occurred which determine the change in the basis or method of computing the amount of such liability and, in which, the amount thereof (whether increased or decreased) can be determined with reasonable accuracy.

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

*Example 1.* Assume that during the taxable year 1960, M, a life insurance company, determines that the amount of its life insurance reserves held with respect to a particular block of contracts is understated on

the present basis being used in valuing such liability and that such liability can be more accurately reflected by changing from the present basis to a particular new basis. Assume that M uses such new basis in computing its reserves under such contracts at the end of the taxable year 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine the change in basis and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy. Such change shall be treated as having occurred during the taxable year 1960 whether M determines that its liability under such contracts was understated for the first time during 1960, or that its liability under such contracts has, in fact, been understated for a number of prior years.

*Example 2.* Assume the facts are the same as in example 1, except that during the taxable year 1960 the insurance department of State X issues a ruling, pursuant to authority conferred by statute, requiring M to use the particular new basis which more accurately reflects its liability with respect to such contracts and that as a result of such ruling, M uses the new basis in computing its reserves under such contracts for the taxable years 1958, 1959, and 1960. Under the provisions of section 818(a) and subparagraph (1) of this paragraph, the change in basis for purposes of sections 806(b) and 810(d) occurs during the taxable year 1960, the year in which all the events have occurred which determine that a change in basis should be made and the amount of any increase (or decrease) attributable to such change can be determined with reasonable accuracy.

[T.D. 6558, 26 FR 2785, Apr. 4, 1961]

### § 1.818-3 Amortization of premium and accrual of discount.

(a) *In general.* Section 818(b) provides that the appropriate items of income, deductions, and adjustments under part I, subchapter L, chapter 1 of the Code, shall be adjusted to reflect the appropriate amortization of premium and the appropriate accrual of discount on bonds, notes, debentures, or other evidences of indebtedness held by a life insurance company. Such adjustments are limited to the amount of appropriate amortization or accrual attributable to the taxable year with respect to such securities which are not in default as to principal or interest and which are amply secured. The question of ample security will be resolved according to the rules laid down from

time to time by the National Association of Insurance Commissioners. The adjustment for amortization of premium decreases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. The adjustment for accrual of discount increases the gross investment income, the exclusion and reduction for wholly tax-exempt interest, the exclusion and deduction for partially tax-exempt interest, and the basis or adjusted basis of such securities. However, for taxable years beginning after May 31, 1960, only the accrual of discount relating to issue discount will increase the exclusion and reduction for wholly tax-exempt interest. See section 103.

(b) *Acquisitions before January 1, 1958.*

(1) In the case of any such security acquired before January 1, 1958, the premium is the excess of its acquisition value over its maturity value and the discount is the excess of its maturity value over its acquisition value. The acquisition value of any such security is its cost (including buying commissions or brokerage but excluding any amounts paid for accrued interest) if purchased for cash, or if not purchased for cash, its then fair market value. The maturity value of any such security is the amount payable thereunder either at the maturity date or an earlier call date. The earlier call date of any such security may be the earliest interest payment date if it is callable or payable at such date, the earliest date at which it is callable at par, or such other call or payment date, prior to maturity, specified in the security as may be selected by the life insurance company. A life insurance company which adjusts amortization of premium or accrual of discount with reference to a particular call or payment date must make the adjustments with reference to the value on such date and may not, after selecting such date, use a different call or payment date, or value, in the calculation of such amortization or discount with respect to such security unless the security was not in fact called or paid on such selected date.

(2) The adjustments for amortization of premium and accrual of discount will be determined:

(i) According to the method regularly employed by the company, if such method is reasonable, or

(ii) According to the method prescribed by this section.

A method of amortization of premium or accrual of discount will be deemed "regularly employed" by a life insurance company if the method was consistently followed in prior taxable years, or if, in the case of a company which has never before made such adjustments, the company initiates in the first taxable year for which the adjustments are made a reasonable method of amortization of premium or accrual of discount and consistently follows such method thereafter. Ordinarily, a company regularly employs a method in accordance with the statute of some State, Territory, or the District of Columbia, in which it operates.

(3) The method of amortization and accrual prescribed by this section is as follows:

(i) The premium (or discount) shall be determined in accordance with this section; and

(ii) The appropriate amortization of premium (or accrual of discount) attributable to the taxable year shall be an amount which bears the same ratio to the premium (or discount) as the number of months in the taxable year during which the security was owned by the life insurance company bears to the number of months between the date of acquisition of the security and its maturity or earlier call date, determined in accordance with this section. For purposes of this section, a fractional part of a month shall be disregarded unless it amounts to more than half a month, in which case it shall be considered a month.

(c) *Acquisitions after December 31, 1957.*

(1) In the case of:

(i) Any bond, as defined in section 171(d), acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under section 171(b) and the regulations thereunder, as if the election set forth in section 171(c) had been made, and

(ii) Any bond, note, debenture, or other evidence of indebtedness not described in subdivision (i) of this subparagraph and acquired after December 31, 1957, the amount of the premium and the amortizable premium for the taxable year, shall be determined under paragraph (b) of this section.

(2) In the case of any bond, note, debenture, or other evidence of indebtedness acquired after December 31, 1957, the amount of the discount and the accrual of discount attributable to the taxable year shall be determined under paragraph (b) of this section.

(d) *Convertible evidences of indebtedness.* Section 818(b)(2)(B) provides that in no case shall the amount of premium on a convertible evidence of indebtedness (including any bond, note, or debenture) include any amount attributable to the conversion features of the evidence of indebtedness. This provision is the same as the one contained in section 171(b), and the rules prescribed in paragraph (c) of § 1.171-2 shall be applicable for purposes of section 818(b)(2)(B). This provision is to be applied without regard to the date upon which the evidence of indebtedness was acquired. Thus, where a convertible evidence of indebtedness was acquired before January 1, 1958, and a portion or all of the premium attributable to the conversion features of the evidence of indebtedness has been amortized for taxable years beginning before January 1, 1958, no adjustment for such amortization will be required by reason of section 818(b)(2)(B). Such amortization will, however, require an adjustment to the basis of the evidence of indebtedness under section 1016(a)(17). For taxable years beginning after December 31, 1957, no further amortization of the premium attributable to the conversion features of such an evidence of indebtedness will be taken into account.

(e) *Adjustments to basis.* Section 1016(a)(17) (relating to adjustments to basis) provides that in the case of any evidence of indebtedness referred to in section 818(b) and this section, the basis shall be adjusted to the extent of the adjustments required under section 818(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years.

The basis of any evidence of indebtedness shall be reduced by the amount of the adjustment required under section 818(b) (or the corresponding provision of prior income tax laws) on account of amortizable premium and shall be increased by the amount of the adjustment required under section 818(b) on account of accruable discounts.

(f) *Denial of double inclusion.* Any amount which is includible in gross investment income by reason of section 818(b) and paragraph (a) of this section shall not be includible in gross income under section 1232(a) (relating to the taxation of bonds and other evidences of indebtedness). See section 1232(a)(2)(C) and the regulations thereunder.

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**§ 1.818-4 Election with respect to life insurance reserves computed on preliminary term basis.**

(a) *In general.* Section 818(c) permits a life insurance company issuing contracts with respect to which the life insurance reserves are computed on one of the recognized preliminary term bases to elect to revalue such reserves on a net level premium basis for the purpose of determining the amount which may be taken into account as life insurance reserves for purposes of part I, subchapter L, chapter 1 of the Code, other than section 801 (relating to the definition of a life insurance company). If such an election is made, the method to be used in making this revaluation of reserves shall be either the exact revaluation method (as described in section 818(c)(1) and paragraph (b)(1) of this section) or the approximate revaluation method (as described in section 818(c)(2) and paragraph (b)(2) of this section).

(b) *Revaluation of reserves computed on preliminary term basis.* If a life insurance company makes an election under section 818(c) in the manner provided in paragraph (e) of this section, the amount to be taken into account as life insurance reserves with respect to contracts for which such reserves are computed on a preliminary term basis may be determined on either of the following bases:

(1) *Exact revaluation method.* As if the reserves for all such contracts had been