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INTERNAL REVENUE SERVICE
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MEMORANDUM for MARY JANE SCIASCIA
ISP - LIFE INSURANCE

FROM: MARSHALL FEIRING
SENIOR TECHNICIAN REVIEWER
CC:DOM:FI&P:2

SUBJECT: Policyholder Loans

This is in response to your request for technical assistance regarding when a life insurance company should include in income the interest on a policyholder loan. Ordinarily, interest on a policyholder loan is due (in full) when the loan originates and each time the loan renews. For this reason, interest on a policyholder loan is often referred to as “prepaid interest.”

ISSUE

Do the "claim-of-right" doctrine and Rev. Rul. 58-225, 1958-1 C.B. 258, require insurance companies to include prepaid interest in income at the time the interest is due?

CONCLUSION

The "claim-of-right" doctrine and Rev. Rul. 58-225 no longer require insurance companies to include prepaid interest in income at the time the interest is due. Under current law, therefore, prepaid interest reduces a loan’s issue price. The adjustment for prepaid interest does not represent an immediate charge for the use of money. Instead, it creates or increases the difference between the loan’s issue price and the loan’s stated redemption price at maturity, resulting in original issue discount (OID) that must be accrued over time.

FACTS

Most life insurance companies allow a policyholder to borrow against the policy in an amount up to the cash surrender value. Ordinarily, the company calculates interest with reference to the policy year (the twelve-month period starting on the anniversary of the policy issue date) and considers the interest due and payable in advance. Thus, when the loan originates, interest is due for the period starting on the loan date and ending on the last day of the policy year. Similarly, when the loan renews, interest is due for the period starting on the first day of the policy year and ending on the last. A policyholder can satisfy its obligation by paying the interest in cash, having it subtracted from the amount borrowed, or having it added to principal.

A policyholder may repay the loan at any time, but ordinarily the loan terminates when the principal balance equals the cash surrender value or the insured dies. If the loan is repaid or terminates before the end of the policy year, the company usually credits the policyholder with any unearned interest.

Before 1995, most insurance companies accepted a long line of cases requiring them to include prepaid interest when due (that is, on the day the loan originated and on the first day of each succeeding policy year). Beginning in 1995, however, insurance companies asked to change to a method by which prepaid interest is includible as it accrues ratably throughout the year. These requests were directly linked to a change in the OID regulations. On the filing of a timely and complete request, the National Office generally has granted the companies permission to change their accounting methods.

LAW AND ANALYSIS

A. The Application of Section 1272 to Life Insurance Companies

Section 1272(c)(2) of the Internal Revenue Code exempts life insurance companies from having to include OID over the term of a loan on an economic-accrual basis. Nevertheless, insurance companies have limited discretion in choosing a method of accounting for discount on policyholder loans. Under section 811(b)(1), insurance companies must account for OID (as defined in section 1273) using an accrual method that is both regularly employed by the company and reasonable.

B. Final OID Treasury Regulations

On February 2, 1994, the Service published final rules for the treatment of OID, de minimis OID, stated interest, and unstated interest. See generally sections 1.163-7, 1.446-2, 1.483-1 through 1.483-3, 1.1001-1(g),1.1012-1(g), and 1.1271-0 through 1.1275-5 of the Income Tax Regulations (the final OID regulations). In general, the final OID regulations are effective for debt instruments issued on or after April 4, 1994. A taxpayer, however, may rely on the final OID regulations for debt instruments issued on or after December 22, 1992, and before April 4, 1994.

Section 1.1273-(2)(g) of the final OID regulations provides that a payment from the borrower to the lender (other than a payment for property or for services provided by the lender, such as commitment fees or loan processing costs) reduces the issue price of the debt instrument evidencing the loan. Under this regulation, a payment from the borrower to a lender at the inception of a loan, even if it is labeled as "prepaid interest," merely represents an adjustment to the loan's issue price. It does not constitute interest income. The drafters of the regulations understood this change eliminates the line of cases requiring prepaid interest to be included in income when it is due. See, e.g., Northern Life Insurance Co. v. United States, 685 F.2d 277 (9th Cir. 1982), cert. denied, 439 U.S. 821 (1978); Union Mutual Life Insurance v. United States, 570 F.2d 382 (1st Cir. 1978); Jefferson Standard Life Insurance Company v. United States, 408 F.2d 842 (4th Cir. 1969), cert. denied, 396 U.S. 828 (1969); Franklin Life Insurance Co. v. United States, 399 F.2d 757 (7th Cir. 1968), cert. denied, 393 U.S. 1118 (1969).

C. Claim-of-Right Doctrine

The claim-of-right doctrine was enunciated by the Supreme Court in North American Oil Consolidated v. Burnet, 286 U. S. 417 (1932), XI-1 C.B. 293. In North American, the taxpayer was in possession of oil property to which the United States held legal title. The United States claimed beneficial ownership and instituted legal action. While this action was pending in 1916, a court appointed a receiver who collected the income earned from the property. In 1917, North American prevailed against the government in district court, and the receiver paid North American the earnings from the earlier year. Subsequently, the government appealed the district court decision with the parties ultimately settling the litigation in 1922. In later tax litigation, the Supreme Court was asked to decide which year the earnings were includible in income. The Court held that the income was includible in 1917, stating "[i]f a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return [report on a tax return], even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." (Citations omitted).

Rev. Rul. 58-225 cites North American in support of the proposition that interest collected in advance constitutes taxable income in the year received, even though the lender employs an accrual method of accounting.

Under the final OID regulations, the adjustment for prepaid interest increases the spread between the amount loaned and the amount due at maturity and does not represent "earnings" on the date the loan originates or renews. The "claim-of-right" doctrine, therefore, does not apply. For the same reason, Rev. Rul. 58-225 is inapplicable. Moreover, although Rev. Rul. 58-225 contradicts the final OID regulations, it lacks the legal force and effect of the regulations. See sections 7.01(4) and (5) of Rev. Proc. 89-14, 1989-1 C.B. 814. The introduction to the Internal Revenue Bulletin makes clear that revenue rulings are merely the Service's conclusion as to the application of the law to the stated facts involved. See, e.g., 1958-1 C.B. 1. Consequently, the final OID regulations have made Rev. Rul. 58-225 obsolete[1].

In light of how the final OID regulations treat prepaid interest, the National Office believes that allowing insurance companies to use the constant yield-to-maturity method for accounting for prepaid interest is reasonable within the meaning of § 811(b).

cc: Mark Smith
Chief
CC:DOM:FI&P:4

Diane Helfgott
Attorney
CC:NER:NJD:NEW
1 Newark Center Suite 1500
Newark, NJ 07102-5224

[1] Revenue rulings are usually declared obsolete in groups and as part of a single project. We will try to make Rev. Rul. 58-225 part of the next such project.