

Revenue Ruling 73-482

Interest on life insurance policy loan; when deductible. Interest deducted in advance from the amount of a life insurance policy loan, or due and unpaid interest added to the principal of the loan, is deductible as "interest paid" under *section 163 of the Code* by a calendar-year, cash-method taxpayer only for the taxable year in which actual payment is made; *Rev. Rul. 67-258, 1967-2 C.B. 68*, distinguished.

Advice has been requested as to when interest is allowable as a deduction for Federal income tax purposes under the circumstances described below.

On April 1, 1970, the taxpayer, who files his Federal income tax returns on a calendar year basis and uses the cash receipts and disbursement method of accounting, borrowed \$1,000 on his life insurance policy. The loan agreement required that interest on the loan be paid in advance, and the insurance company paid the taxpayer \$950 retaining \$50 as interest. On April 1, 1971, interest for the period of April 1, 1971, to April 1, 1972, became due but the taxpayer made no payment. Therefore, the insurance company treated the unpaid interest as an additional policy [*2] loan and added the amount thereof to the principal. The taxpayer paid the entire loan principal and interest on March 31, 1972.

Section 163 (a) of the Internal Revenue Code of 1954 provides, in general, that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

Section 1.461-1 (a) (1) of the Income Tax Regulations provides the general rule that under the cash receipts and disbursements method of accounting, amounts representing allowable deductions are to be taken into account for the taxable year in which paid.

In *John Randolph Hopkins, 15 T.C. 160, 181 (1950)*, acq., *1951-1 C.B. 2*, a taxpayer using the cash receipts and disbursement method of accounting, obtained a \$10,000 4-year interest bearing loan for which he was charged a \$1,500 bonus receiving only \$8,500 from the lender. The taxpayer claimed an interest deduction computed on the basis of allocating the \$1,500 bonus over a 5-year period. The Tax Court of the United States, citing *John C. Cleaver, 6 T.C. 452 (1946)*, *aff'd, 158 F. 2d 342 (7th Cir. 1946)*, *cert. denied, 330 U.S. 849 (1947)*, held that since the taxpayer was on the cash basis he was only entitled to a deduction for [*3] interest actually paid in the tax years involved and that whether called discount, interest, or "bonus", the \$1,500 difference between the principal amount of the loan and the amount actually received by the taxpayer was not deductible as "interest paid" in the year of borrowing. The court also held that upon repaying the \$10,000 in a lump sum, the taxpayer was entitled to an interest deduction of \$1,500 in the year it was paid. In addition, the court stated that if instead of repaying in a lump sum, the taxpayer had paid installments, he would be entitled to an interest deduction based upon the aliquot portion of each payment that was attributable to interest.

Where interest on life insurance policy loans is added to the principal of the loans when it becomes due but remains unpaid, it is not deductible as "interest paid" within the taxable year by a taxpayer on the cash receipts and disbursement method of accounting. See *Nina Cornelia*

Prime, 39 B.T.A. 487 (1939), *Albert J. Alsberg*, 42 B.T.A. 61 (1940), and *L.B. Hirsch*, 42 B.T.A. 566 (1940).

Accordingly, in the instant case, the taxpayer is entitled to deduct the interest only in his calendar taxable year 1972 when he actually paid [*4] it and not for the year in which the interest was deducted from the loan by the lender or added to the principal of the loan.

Rev. Rul. 67-258, 1967-2 C.B. 68, involving an annuity contract, is distinguishable since the advances made to the employee in the form of a return of consideration were deemed to be amounts received under the contract and did not serve to create a creditor-debtor relationship.

Rev. Rul. 67-258, 1967-2 C.B. 68, is distinguished.