IFLR
INTERNATIONAL FINANCIAL LAW REVIEW
INTERNATIONAL BRIEFINGS 2015

US

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Negative interest rate consequences

Over the last few months, the financial press has been filled with reports of negative interest rates. For example, on December 18 2014, the Swiss National Bank announced that it would move from a zero percent interest rate to a charge of 0.25% on deposits from commercial banks. This creates a negative interest rate on Swiss National Bank deposits. On June 18 2015, the Swiss National Bank announced it would maintain a rate of negative 0.75%, which has now remained unchanged since January.

In mid-May, Portugal sold a six-month government bond at a negative interest rate of 0.002%. In late March, GDF Suez sold a two-year zero yield bond. Some lucky Europeans have actually benefitted from negative interest rates on consumer loans.

In Europe, one reads negative interest exists because the European Central Bank is flooding Europe with liquidity under its equivalent of quantitative easing. In the case of Switzerland, the move was aimed at weakening the Swiss franc, which ended its currency peg to the euro in January.

Negative interest occurs at issuance when a lender lends money to a borrower and the borrower agrees to repay less than the amount loaned. Some view this as a premium for a loan or as a charge against the lender for holding its money. For an outstanding loan, negative interest can occur when a floating rate declines below zero. For example, if a mortgage loan in Spain was originally issued at a rate equal to one-month Euribor (Euro Interbank Offered Rate), that rate as of mid-June is below zero. Whether the lender must pay the borrower in this case depends on the underlying contract. Finally, a bond originally issued with a positive yield can trade at a negative yield. For example, right now in Europe certain sovereign debt trades at a negative yield.

As one might imagine, there is little authority on negative interest for US federal income tax purposes. However, in a little-noticed change to certain regulations that were proposed in 2013 and finalised a year ago, the IRS (Internal Revenue Service) seems for once to be ahead of the curve. Under US tax principles, the excess of a debt instrument's issue price over its stated redemption price at maturity is treated as bond premium. A holder can elect to amortise this bond premium. The amortised premium offsets interest income on the bond. If there is unamortised bond premium at maturity (for example, if there is no interest on the bond against which to offset the premium), the holder would otherwise have a capital loss. The change in the regulations permitted holders to claim an ordinary loss for the unamortised premium.

Another alternative would be to treat negative interest as a fee. Therefore, the negative interest rate would be viewed as akin to a fee paid for the use of a safe deposit box. The fee paid by the depositor might be a trade or business expense (in the case of a corporation), which should generally be deductible. In fact, JP Morgan announced in February that the bank would charge its largest customers a fee for holding large cash balances with the bank.

Another issue is whether a US investor that buys a negative interest bond from a foreign issuer must withhold tax on the interest. The Securities Industry and Financial Markets Association recently wrote a letter to the Treasury raising this question. It seems farfetched, because the source of the borrower's income logically seems to be foreign; however, given the numbers, US investors are hoping for some clarification.

Whether negative interest disappears before the IRS has a chance to act is another question.

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