Negative Interest Rates–Tax Issues for Investors

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Negative interest rates are prevalent in Europe, and the possibility of rates going below zero in the U.S. is increasing. The authors review the unique tax issues negative interest rates would raise.

Introduction

While countries in Europe already have negative interest rates, this has not yet occurred in the United States on a regular basis. However, if it does occur, tax issues will inevitably arise because the tax code doesn’t easily contemplate negative interest rates.

Investors could encounter negative interest rates in a variety of ways. For example, investors looking for a short-term place for their money could make a deposit into a savings account at a bank and the depositor would pay a fee to the bank on a regular (monthly, annual) basis rather than being credited interest. Alternatively, an investor could buy a bond with a zero (or a nominal) interest rate and pay a premium in excess of the maturing value of the bond. Or the investor could invest in a money market fund. It appears that each method has a different tax treatment.

The basic definition of interest expense for tax purposes is that it is an expense incurred for the use of money. In each of the above scenarios, the person incurring the expense or loss isn’t paying for the use of money. Therefore, it doesn’t appear that negative-interest-rate-related payments would be treated as interest expense for tax purposes.

As a First Step, Elect Amortization

No, amortization is not the name of yet another 2020 presidential candidate. It refers instead to a taxpayer’s ability to elect under Internal Revenue Code Section 171 to reduce the amount of taxable interest income in a year by the

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amount of premium allocable to the year for the bond. In a positive interest rate environment, paying a premium occurs when purchasing a bond in the secondary market with a stated interest rate that is higher than current rates.

As an example, if current one-year interest rates were 1 percent, you would pay $103 for a $100 bond issued with a 4 percent coupon that now comes due in one year. If you do not elect to amortize, you would wind up with 4 percent in taxable interest and 3 percent in capital losses that you may not be able to utilize. If instead you make the proper election, you have only 1 percent in taxable interest income and no capital losses.

The government suggests that investors make the election by attaching a statement to their tax returns. (This would need to be done only once.) We can’t think of a scenario where an investor would be disadvantaged by making this election. Note that, because the IRS doesn’t want investors in tax-exempt bonds generating capital losses from paying a premium for a high coupon muni, amortization is mandatory and automatic for munis, thus denying the capital loss.

For U.S. Tax Purposes How Would Payments Made by a Depositor to a Bank Be Treated?

In the savings account situation presented in the Introduction to this article, it looks like the fee is being paid to the bank because the depositor trusts the bank with the money and would rather incur the expense than put the money elsewhere and take a risk on getting back even less. For tax purposes, this type of expense appears to be related to property held for investment (under Section 212). However, under changes made by the Tax Cuts and Jobs Act of 2017 (TCJA), individuals will not be allowed to deduct these expenses because they are miscellaneous itemized deductions.¹

Section 171 Allows an Offset Against the Stated Interest Received on a Bond But What if Rates Go Negative and the Premium Paid Is Larger Than the Stated Interest Rates?

In the bond purchase described earlier, the investor would be buying a bond the cost of which would exceed the amount to be received upon redemption of the bond. If the investor makes a proper election, the excess is treated as bond premium under Section 171. Under normal conditions, with positive interest rates, the amount of premium would be less than the interest that would be earned over the life of the bond. In that situation the entire premium

¹ P.L. 115-97, § 11045(a), 131 Stat. 2054, 2088 (adding IRC § 67(g), suspending the deductibility of any miscellaneous itemized deductions for taxable years 2018 through 2025).
would be amortized over the life of the bond and would reduce the amount of taxable interest income on the bond.

In a negative interest rate environment, the amount of the premium would be in excess of the interest earned on the bond. While the drafters of Section 171 did not have negative interest rates in mind, subsequent regulations appear to address the situation. Under the regulations, the amount of the premium to be deducted should be determined by using the investor’s yield to maturity on the bond. In this case, the yield will be negative but the amount of premium to be deducted can still be calculated. However, under Section 171(e) and the regulations thereunder, the amount of the deduction in any year is limited to the amount of interest income earned in that year on the bond or the excess of interest income over amortized premium in prior years. If there is an excess, such excess should be carried forward to the following year. The regulations state that if there is a bond premium carryforward as of the end of the accrual period in which the bond is retired, the investor treats the amount of the carryforward as a bond premium deduction for the year in which the bond is retired. The regulations state that the excess is allowed as a deduction under Section 171(a), which is an ordinary deduction. This deduction was not affected by the TCJA and is a viable deduction. In this case, the excess paid for the bond, which represents negative interest, should be deducted as an ordinary deduction in the year the bond is sold or matures. The regulations also state that any premium that exceeds the interest income on a tax-exempt obligation shall be treated as nondeductible loss.

While the bond investor is getting an ordinary deduction for the negative interest, the deduction is being deferred until the bond matures. Economically, the value of the bond is decreasing over its life and the investor should have been allowed to deduct the negative interest as it accrued over time if taxes followed economics. The taxation of premiums in a positive interest rate world does exactly that. It equates the investor’s economic interest income with the amount of taxable interest income.

However, the bond investor in the second situation is better off than the depositor in the first situation. Both the bond investor and the bank depositor described above are incurring a negative interest cost. However, in the first scenario the depositor does not get a tax deduction for the cost while the investor in the second scenario gets a deferred tax deduction.

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6 Id.
What about the person who chose to put her money in a money market fund? An investor in a money market fund that is investing in a negative interest rate environment would incur the negative interest as a decrease in Net Asset Value, and thus a capital loss upon disposition.

**Items the Government Might Want to Address**

If negative interest rates become a reality in the U.S., investors would hope that Congress enacts tax legislation or the Treasury writes regulations under existing law to deal with these issues as it already has done for bond investors.

In this article, we’ve looked at investors. But what if a taxpayer *borrows* at a negative interest rate? Denmark’s third-largest bank is offering 10-year mortgages with an interest rate of negative 0.5 percent. Putting aside any other fees the bank may charge, the debtors will pay the bank less than they initially borrowed. Does the borrower have taxable income each year as the loan balance decreases?

Myriad tax issues relating to other interest rate based transactions as well as sourcing issues with respect to foreign or domestic income and expense will need to be addressed. A world of negative interest rates may seem implausible to American investors but, with rates already in negative territory in Europe and Japan, there’s no reason to think the U.S. can’t find itself in the same situation.