A Tax arbitrage is a strategy that allows clients to convert one type of income into a more-favorably-taxed type of income.

As an example, interest income is taxed at a maximum rate of 39.6% while long-term capital gains are taxed at a more favorable rate of 20%. Arbitrage seeks to take advantage of that difference.

Sometimes, exploiting such a difference entails complex transactions. Other times, a quite simple action can accomplish the goal.

Interest rates at historic lows offer a rare and very simple opportunity to employ tax arbitrage. This trade turns higher-taxed interest income into lower-taxed long-term capital gains.

TIME TO HARVEST

In the current low-interest-rate environment, many investors have unrealized capital gains on bonds that they hold. We suggest that clients holding taxable bonds harvest their unrealized capital gains.

Although the mantra of tax-efficient investing is to harvest losses and defer gains, one strategy recommends doing the opposite. This is the exception that proves the rule. By harvesting gains, you can turn what would have been taxed at 39.6% for a HNW client into income taxed at 20% or maybe even 0%.

Let’s say your client bought the 5% Treasury note when it was issued at par a few years ago. Let us also assume that this bond has one year left to maturity. Because the bond has a high coupon interest rate in comparison with current rates; the bond is trading at a premium (a price above par). If current interest rates for one-year paper are 0.5%, the bond will be trading at 104.5 so that it too yields only 0.5%.

If the client does nothing over the next year, she will receive $5 in interest income, and this will be taxed at 39.6%.

But if, instead, the client sells the bond and then turns around and buys it back, she will then have only 50 cents of interest income taxed at 39.6% and $4.50 taxed at the lower long-term capital gains tax rate.

That’s right, the client’s economic position stays exactly the same, but the taxes are cut dramatically.

KEY DEDUCTION

When any investor purchases a taxable bond at more than the face value that she will receive at maturity, she is allowed under Internal Revenue Code Section 171 to deduct that premium from the interest received.

This deduction properly allows an offset to the high interest income; if no deduction were allowed, a client buying the same bond at 104.5 would have $5 in interest income and a $4.50 capital loss. Many clients cannot use capital losses and this would be a tax whipsaw for them that could affect the market for the bonds.
Thus, we have Section 171 governing the amortization of bond premium. Here, the amortization rules reduce the $5 of interest she receives by the $4.50 premium she paid (to arrive at only 50 cents of taxable interest income). By the way, the amortization is now done automatically by brokers preparing 1099s for clients. Taxwise, the wash sale rules do not apply to gains, only to losses. If you sell something for a profit and three days later buy it again, the government does not let you off the hook for the taxes on the gains.

WRINKLES TO CONSIDER

Cutting taxes almost in half is intriguing, but there are some more wrinkles to think through before you act. For those with capital-loss carryforwards, the transaction is even better. When one has capital losses, those losses are not currently deductible but can be used to shelter realized capital gains. Because the harvested gain will be offset by those losses, there will be no tax to pay next April 15.

Here the client uses loss carryforwards to completely eliminate the 39.6% tax that would have been imposed on the interest income if the client had done nothing but continue to passively hold the bonds.

There are corporate bonds, municipal tax-free bonds and U.S. government bonds. Each has a unique set of possibilities.

We would advise that you do not harvest gains on munis. If you do, you will be turning what would have been tax-free income into taxable long-term gains, thereby increasing your tax bill, not decreasing it.

If the client lives in a state that has an income tax, there is a tax drag on the trade if he is harvesting a government bond. U.S. government interest income is usually exempt in the states that tax income.

Because those same states will tax any capital gains that are realized, in these circumstances we are increasing the state tax while lowering the federal tax. The increased state tax comes from converting what would have been tax free in the state into capital gains that will be taxed in the state. Note that there is no state effect when harvesting gains on a corporate bond.

TAXING QUANDRY

In the above example, the client is realizing taxable income earlier than what would have happened had he not harvested the gain. Yes, that gain is taxed at only 20%, but that tax is paid next April.

If the bond had 15 years to maturity, the higher tax rate would be paid over a stream covering 15 years. Is paying 20% in 2016 really better than paying 39.6% over the next 15 years?

In the above example if we use as our investment the capital gains tax that must be paid next April, we can calculate a rate of return on the investment. If the bond was due in 10 years, the after-tax R.O.R. is 11% for a New York state resident. If the bond came due in one year, the after-tax R.O.R. skyrocket to 69%.

If that same one-year bond is a government bond instead of a corporate bond, the 69% rate of return drops to 54%, but that’s still a 54% after-tax return for doing nothing.

ONLINE CALCULATOR

The website of my company, Twenty-First Securities, offers a profitable bond calculator that takes all of these factors into account and helps the client decide whether he should sell any bond and repurchase.
This calculator assumes that it will cost the investor a quarter of a point in commissions to buy and sell.

For the simplicity of the example in this article, we assume the investor will buy and sell the same bond, but the investor can buy any new bond that he would like and still reap the benefits.

The tax magic is in converting future interest income into a current long-term gain and this is accomplished once you sell the bond and take the long-term gain.

In short, you should take long-term gains on your taxable bonds.

The higher the coupon, the more taxes that are saved; state tax can be a drag on harvesting government bonds but not enough to overwhelm the federal benefit; and the shorter the time to maturity, the higher the rate of return on your money.