Consider Taking Bond Profits

Here's why paying long-term capital gains taxes may be good for your fixed-income clients.

By Robert N. Gordon

Today, many investors are focused on the losses in their equity portfolio. But instead of wringing our hands, let's take a look at one of the bright spots in many investors' holdings — bonds.

As interest rates have fallen, the price of most bonds has risen dramatically. Investors who purchased taxable bonds with high coupons in the past often are holding greatly appreciated assets. These assets can produce handsome profits and require your client to do very little. In fact, the tactic I'm about to suggest can earn clients over 10 percent after-tax.

Here's the strategy for those who have owned a profitable bond for more than one year: Sell the bond, then immediately repurchase it and amortize any premium.

Of course the main drawback associated with a profitable bond sale is that the seller will be subject to an immediate capital gains tax. But in exchange for paying this 20 percent capital gains tax immediately, the investor should decrease his taxable bond income in the years remaining until maturity while still receiving the same cash flow.

Since bond income is currently taxed at 38.6 percent, amortizing the repurchased bond's premium enables the investor to pay tax only on the bond yield, not the high coupon.

Let's take a specific example. Suppose that in 1994, an investor had purchased a bond at par paying 6 percent annual interest. The bond has three years remaining until maturity. With current three-year bonds yielding 2 percent, the bond is now selling at a premium, for $112 (which represents the 6 percent annual coupon minus 4 percent a year in price erosion). If the investor simply holds the bond until maturity, he will receive interest payments of $6 each year for three years.

Conversely, if the investor sells the bond for $112, he or she pays a long-term capital gain tax (at 20 percent) of $2.40, payable on the following April 15th. After the sale, the investor then repurchases the bond at its $12 premium and amortizes that premium. The amortizing of the premium reduces the investor's basis in the bond so that at maturity the investor will have neither a gain nor a loss on the bond. Therefore the investor only pays taxes (at 38.6 percent) on the 2 percent yield, not the 6 percent coupon.

By selling and repurchasing the bond, the investor has reduced taxes on the investment and earned a 40.61 percent after-tax internal rate of return. And all this was accomplished through a simple strategy that entails very little additional economic risk.

This tactic can earn clients over 10 percent after-tax.

If the same bond were due to mature in less time, the internal rate of return would increase. Conversely, using a bond due to mature in 10 years, say, still yields 12 percent after tax.

Commissions would obviously reduce the return to the investor, assuming that a quarter of a point commission would lower the return to 34.54 percent on the three-year bond and to 10.67 percent on the 10-year.

Investors with capital losses — not too rare these days — can use those losses to offset the capital gains tax triggered by the bond sale. By engaging in the sale and immediate repurchase of the bond and applying existing capital losses against gains, an investor could more than double the benefit.

This sale-buyback technique works best for corporate bonds, but it is less robust for government issues, and ineffective for municipal bonds. Twenty-First Securities has developed an online profitable bond calculator to compute the benefits associated with this strategy using different investment parameters. It is available free at the company's website. OWS

Bob Gordon is President of Twenty-First Securities Corp. (www.twenty-first.com), an adjunct professor at New York University's Graduate School of Business and a member of the Wall Street Tax Association. He is also the author of "Wall Street Secrets for Tax-Efficient Investing" (Bloomberg Press.)

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