

## The Magic of Swaps

This institutional tool offers many advantages for affluent individual investors.

By Robert N. Gordon



Last month, we discussed listed index options as an appropriate investment for investors with time horizons of less than one year. This month, let's explore the perfect investment structure for extremely wealthy clients looking beyond a 12-month time frame: total return swaps.

First, a definition. A swap is a contractual agreement under which two parties exchange payments based on the price changes and distributions from a security, as well as the cost to carry the security. Investors retain all the upside and downside of the designated security, but keep the cash they would have invested.

It is possible to enter into a swap on many underlying vehicles, including equities, an index, a debt security or a commodity. The payoff can be tied either to a long or to a short position. Swaps' profits can be taxed as either ordinary income or capital gain, and so can swap losses. The choice is in the investor's hands — and it need not be made until the results of the swap are known.

Ordinary losses normally would be better than capital losses, as capital losses are deductible only against capital gains. Capital gains, taxed as low as 18 percent, usually are more attractive than ordinary income, which is taxed at 38 percent.

Under law, payments made or received under a swap contract are ordinary income, but if the contract is terminated early, any payments then exchanged are considered capital in nature. If the swap turns out to be profitable, all the investor needs to do is close out the contract before the end. Any early termination payment received would be a capital gain. If the swap has been held for more than one year, a 20 percent tax would apply. If more than five years have elapsed, the tax would be even lower — 18 percent. For this reason, we suggest swaps that are five-and-one-half years at inception.

If the swap moves against the investor, the best approach

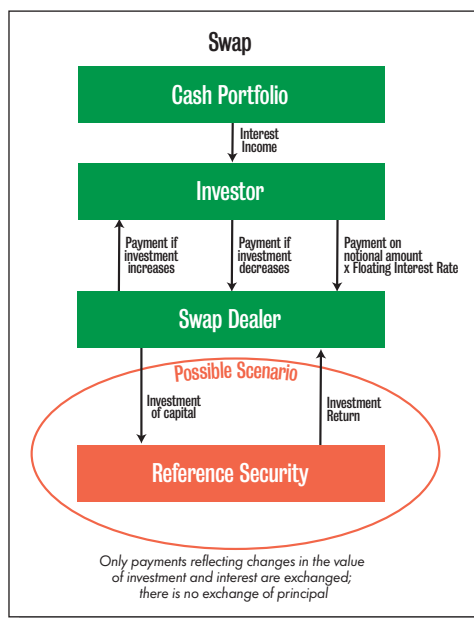
is usually to maintain the contract until its end. With this approach, the final payment would be an ordinary loss deductible against salary and other income. However, the ordinary deductions from carrying charges and price movements are miscellaneous itemized deductions that are deductible only to the extent that they exceed 2 percent of adjusted gross income. If these are less desirable, the investor can just terminate early for capital treatment.

The investor's net profit (or loss) of investing through a swap would be the difference between the interest earned on the cash and the floating interest rate charged on the swap. Any dividends or interest that would have been earned on the security used for the swap would not be currently received but instead would be deferred to termination and converted into long-term gains.

Despite their attraction, swaps have drawbacks, including the fact they are largely an institutional product. Most swap dealers won't give a good price on a swap unless its notional amount exceeds \$3 million. A client's single position, therefore, must exceed that amount. Also, the

CFTC has ruled that to be a Qualifying Swap Participant an investor must have at least \$10 million in gross assets. Finally, swaps lose their allure when written on flow-through vehicles such as hedge funds or mutual funds because of "Constructive Ownership Rules."

The diagram above shows the parties involved in a swap and their likely investment postures as the swap is held instead of the asset itself. **OWS**



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