

Bond swapping



Wealth
Management

Tax savings and much more

Bond swaps are an excellent strategy to accomplish a number of investment goals. In many cases, investors rely on bond swaps to take losses on depreciated holdings in order to benefit from tax savings. Fortunately, there's much more to bond swaps than simply taking losses. Investors should also consider bond swaps for taking profits and accomplishing other goals such as increasing yields, improving quality, or consolidating smaller positions.

What are bond swaps?

A bond swap is simply the sale of bonds from your investment portfolio and the subsequent purchase of replacement bonds. Investors often engage in bond swaps close to year-end in order to realize tax benefits. They do this by taking a loss on the sale of a depreciated bond and using that loss to offset capital gains on their tax returns, thus avoiding the tax. The IRS procedure to do this is to first offset short-term losses against short-term gains, then offset long-term losses against long-term gains. Finally, these two net results are combined to produce a final net gain or loss. This final gain or loss is subject to different tax treatments, however, which investors should be aware of when executing bond swaps.

- **Losses** — You can utilize all short- and long-term losses from the sale of your bonds to offset any short- and long-term capital gains. An investor who has losses on bonds held more than 12 months must use the losses first to offset any long-term capital gains; long-term losses in excess of long-

term gains can be applied to short-term gains. Similarly, losses on bonds held for 12 months or less must first be applied to any short-term gains.

- **Gains** — An investor realizing a final gain will experience different tax implications, depending on whether the gain is a net short- or long-term gain. Short-term gains are taxed at the same rate as ordinary income, while long-term gains are taxed at a maximum 20% rate.

Other bond swap benefits

While realizing profits and losses are the central goals of bond swaps, there are other important reasons to consider this investment strategy. It provides an excellent opportunity to evaluate your investment goals and adjust your bond holdings accordingly. For example, you may want to increase your current income. To accomplish this, you might sell your present bonds and purchase bonds with higher coupons. Or perhaps you want to extend the maturity range of your bond portfolio, or consolidate smaller holdings. You can satisfy all of these objectives with bond swaps.

Avoid wash sales

If your goal is to reduce taxes with bond swaps, one point to remember is to avoid "wash sales," which would void your tax loss. Wash sales occur when you sell a bond, and within 30 days, before or after, purchase the same or nearly-identical bond as the one sold. (In this case, the IRS considers that you sold the bond simply for the tax write-off.) Generally, you can avoid a wash sale by ensuring that two of the following three characteristics of the bond are different: issuer, coupon, and maturity. This should be easy to do given the many bond offerings available.

Tax reform may still arrive

Congress is always considering tax reform proposals which could affect the tax treatment of capital gains and losses. Investors should keep in mind that a loss not taken in this tax year may not necessarily qualify for a full tax deduction in a future year.

Following is a worksheet that illustrates some points to consider, relevant to bond swaps. We recommend that

you meet with your RBC Wealth Management financial advisor as well as your tax advisor to determine how bond swaps can work for you.

Potential benefits of bond swapping

- Realize losses for tax savings
- Take advantage of changing market conditions
- Recognize gains
- Improve quality
- Increase yield
- Boost annual income
- Consolidate small positions
- Shorten or extend maturities
- Enhance liquidity and diversification

Bond swap example

Sell		Buy
\$100,000	Par value	\$90,000
ABC	Issue	XYZ
3.00%	Coupon	4.00%
2018	Maturity	2018
4.00%	Yield to maturity	4.00%
89.397	Price	100
Aaa/AAA	Rating	AAA

Results

Quality	Maintained
Maturity	Maintained
Annual income	Increased \$600 per year
Yield to maturity	Maintained
Cash investment	No cash needed
Original cost	\$100,000
Capital loss	\$10,000

Your bond swap example

Sell		Buy
_____	Par value	_____
_____	Issue	_____
_____	Coupon	_____
_____	Maturity	_____
_____	Yield to maturity	_____
_____	Price	_____
_____	Rating	_____

Your results

Quality	_____
Maturity	_____
Annual income	_____
Yield to maturity	_____
Cash investment	_____
Original cost	_____
Capital loss	_____

RBC Wealth Management is not a Tax Advisor. All decisions regarding the tax implications of your investments should be made in connection with your independent tax advisor.