ADVISORS ASSET MANAGEMENT

Tax Swaps

Take advantage of a tax loss while maintaining or enhancing the income, credit quality, call protection, or maturity of your bond portfolio.

What is a Tax Swap?

In its simplest form, a tax swap is a strategy whereby an investor sells one or a group of fixed-income securities and simultaneously purchases another one or group of securities with the intention of "realizing" a gain or loss on the value of the instrument sold. In practice, the process is slightly more complicated and warrants consideration of several factors, discussed below, before executing.

Generally, investors seek to participate in tax swaps in the fixed income market following a pronounced increase in yields. Such swaps, most commonly referred to as "Tax Loss Swaps," are typically undertaken close to year-end with the investor seeking to optimize their tax liability for the year. Bear in mind, tax swaps can, and often-times should be executed regardless of the time of year during which the opportunity presents. The benefit of "realizing a loss for tax purposes", is that the investor can use the difference between the cost basis for the bond and sale price to reduce tax liability. The loss can be used to offset capital gains or, depending on the current tax code, used to offset up to $3,000 per year of ordinary income — and can be carried forward for future years.

There are inherent risks associated with a tax swap strategy as the security being sold and purchased cannot be identical and may react to different market factors individually. Investors should consider all associated costs including applicable sales charges.

The IRS Wash Sale Rule

Investors should be aware of this rule to avoid negating the tax liability benefit they are seeking. The rule is complex and opaque; therefore, investors are encouraged to seek the advice of a tax advisor before utilizing a tax swap strategy (AAM does not offer tax advice).

A wash sale generally occurs when an investor sells a security at a loss and purchases a "substantially identical" security within 30 days before or after the loss sale. The IRS is unsurprisingly vague with regard to the definition explaining what constitutes a "substantially identical" security. Generally speaking, to avoid running afoul of this rule (as it relates to bonds) an investor should change at least two of the following three aspects of a security sold: 1) the issuer (credit), 2) the coupon rate, or 3) the maturity date.

Tax Swap Benefits

Realize a gain or loss within a portfolio
Improve the underlying dynamics of a portfolio

- *Adjust coupons to change annual income*
- *Upgrade or downgrade credit quality*
- *Extend or shorten interest rate exposure*
- *Increase or decrease diversification*
- *Swap into or out of tax-exempt or taxable securities*

Investor Considerations

- *Most investors prefer to execute swaps with little or no additional proceeds being invested.*
- *Most investors prefer to maintain similar income.*
- *Most investors prefer to either maintain or improve credit quality.*
- *Investors should be aware of the adjusted cost basis for the security they are seeking to sell (such information is typically available on a recent portfolio statement). This is relevant as it could significantly affect the actual loss to be taken when accounting for interest income earned during the relevant holding period.*
- *To effectively execute a tax swap, considering cost and bid-offer spread, investors should typically expect to extend maturity at least two years in order to satisfy the aforementioned considerations.*

Tax Loss Swap Example

Below is an example demonstrating a swap to highlight the opportunity to harvest a loss.

The original purchase of a $100,000 bond position being sold occurred slightly over two years ago. The purchase price yield was at 3.00%, equaling a dollar price basis of $100. The execution of the swap uses a settlement date of today at current market levels, assuming reasonable costs of execution.

B/S	Description	Coupon	Maturity	Market Yield	Market Price	Cost at Purchase	Loss	Annual Income	Proceeds *(incl. interest)*
SELL	Generic Bond A (BBB)	3.000%	3/15/2025	6.000%	$96.000	$100,000	($4,000)	$3,000	$96,417
BUY	Generic Bond B (BBB)	6.125%	10/15/2028	6.125%	$100.000	--	--	$6,125	$101,174

Post-Trade Analysis

- The investor realized a capital loss of $4,000 after adjusting for the cost basis of the security.
- The investor maintained the credit quality of the original security.
- The investor increases annual income.
- The investor contributed a minimal amount of cash to execute the swap.
- The investor extended maturity by about 2.75 years.

Post-Trade Analysis

- Consult with a tax advisor to ensure proper accounting for the tax benefits.
- Avoid waiting until late December. For a number of reasons, the market may become less liquid and an investor's ability to receive best execution for a tax swap may be compromised.
- Investor objectives can change over time and should be considered periodically. An effective tax swap can help investors optimize long-term returns better than a "buy-and-hold" approach.

Contact your financial advisor and/or tax professional to discuss your specific investment objectives and tax situation. If appropriate, they can help structure a tax swap strategy which is appropriate for your financial situation.

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