THE BOND BUYER

Commentary Don't let your tax-loss harvest become a harvest of regret

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Municipal bonds present fertile ground for investment professionals interested in reaping risk- free returns by sheltering gains with well-timed losses. But watch out. The financial literature is filled with misleading information that can send investors down the wrong path— prompting transactions that will ultimately defeat the reason for the strategy.

Investors who set out to harvest tax losses can wind up without the benefit they anticipated. While selling a loser does save tax, holding it could be preferable to selling. 'Tax-loss harvesting' generates more than 320,000 hits on Google, but most of these deal with stocks and ETF's; very few refer specifically to munis. However, munis have unique complexities that may lead well-intentioned financial planners to offer the wrong advice. (As an aside, although most firms have an explicit policy of not offering tax advice, they do so on their web pages.)

This commentary is not about the familiar blunder involving a bond purchased at a premium. Most financial advisors know that in such a case the investor's tax basis gradually declines towards 100 — holding it maturity has no tax consequences. But, say an investor buys a bond at 115 and sells it four years later at 112, when its basis has declined to 110. A naïve calculation would show the loss as 3 points (112 – 115), but it is actually a gain of 2 points (112 – 110). Claiming a 3 point loss might make for an unpleasant tax audit.

To determine if a sale makes sense, it is important to know the value of the after-tax cash flow stream particular to the holder. The calculation should include the present value of any tax due at maturity, which depends on the purchase price. No tax will be due if the purchase price was par or above. On the other hand, if the purchase price was at a discount, below the so- called de minimis level, the gain at maturity is taxed as ordinary income, at a rate of roughly 40%. (Incidentally, it is a common mistake to assume that the 20% long-term capital gains rate applies, once again risking an audit.) Thus the hold value of a bond may differ from investor to investor.

The investor's hold value should be compared to the after-tax sale proceeds (sale price plus tax savings) to determine whether a sale is beneficial. Let's consider the following case. Our investor bought a 9-year 2.5% bond at par 4 years ago. Rates have increased — tax-loss harvesting is most effective in an environment of rising interest rates, because losses occur when interest rates rise. Today the bond has 5 years remaining to maturity, and the current 5- year rate is 3.00%. Thus our investor's hold value is roughly 97.7 (discount a 2.5% 5-year bond at 3% YTM).

But the market price of the bond happens to be only 96.5 (3.26% YTM), rather than 97.7. This is because a new buyer is going to pay a 40% tax on the resulting gain at maturity. You can verify that 96.5 is the fair market price by observing that the resulting after-tax yield, whose calculation incorporates the 1.4 point tax at maturity, is 3.00%. (Note that the bid-ask spread is 0 for this discussion.)

Sell or stay put? The tax saving from sale at 96.5 at the 20% long-term capital gains rate is 0.2(100-96.5) = 0.7, resulting in total after-tax proceeds of 96.5+0.7 = 97.2. But the value of staying put is greater; it is 97.7! Tax-loss harvesting would result in a 0.7 point saving, but also in a 0.5 point (97.7-97.2) loss of value. Thus, the transaction would win on optics but lose where it counts.

In summary, although harvesting a tax loss on a muni would seem straightforward, it's tricky when the bond trades below par. It is easy to make a mistake, because differing tax treatments can make the bond worth more to you than to current buyers. So what may seem like a vanilla tax-loss trade, where you think you're capturing value, could actually be a money-loser. The insidious part is, you wouldn't know it, and neither would your financial advisor, because you don't have the right tools, and it's not something you'll find on Bloomberg.

Proper analytics are essential for tax-loss harvesting. For investors relying on superficial calculations, it could be a harvest of regrets.

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