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How To Reduce Your Taxes By Trading Municipals

This article shows you how to create paper tax losses which can be deducted from capital gains and/or income taxes. The term loss is a misnomer if there ever was one because it's really a gain in the money you gain on April 15th. Admittedly tax swapping is not without costs but if done properly those casts can usually be absorbed in the transaction.

The figures accurately reflect those available on the date this educational article was written (June 10, 2009). Of course, the figures change daily, and certainly from month to month, however, the relationship between the figures remains relatively constant, as do the principles they represent. (You may or may not achieve the same results as those in the example). (Click here for Risk Factors.)

By trading out of some of your municipals and into very similar bonds, it is possible to reduce your taxes at very little actual cost. Because you can get savings in the form of reduced taxes by creating "paper losses" for yourself. The word loss is a misnomer, because when trading your municipals, the net result is really a gain in the amount of money you keep on April 15th.

If you have capital gains that you have taken, you can reduce the taxes due on those gains by trading within your municipal bond portfolio. You can also deduct the "paper losses" from ordinary income (up to $3,000).

All you have to do is sell one bond and buy an almost identical bond at a similar price. If the bond you sell is one in which you have a capital loss, you can get a cash savings for yourself in the form of reduced taxes on April 15th. If done properly, your holdings remain virtually unchanged in terms of quality and maturity range. And the paper loss you register on the sale can be applied against your capital gains on stock, real estate or other investments. In addition, you can deduct up to $3,000 per year from ordinary income with capital losses, and carry them forward for an indefinite period. Be sure to refer to **"About Capital Gains and Losses"** later in this article.

The purpose of these transactions is to lower your capital gains tax and/or income tax. Bond swapping to lower taxes involves selling a bond trading at a price below what you paid, taking the tax deduction as permitted by the IRS, and purchasing a very similar bond at a reasonably similar price.

Admittedly tax trading is not without cost. Trading costs run between ¼% and 2% of the total principal amount depending on lot size, maturity, and quality. But these costs can usually be absorbed in the form of slightly lower coupons or slightly longer maturities.

The easiest trade to make is one in which you replace the bond you sell with an almost identical bond. The dealer's differential between the bid and the asked price usually can be absorbed by purchasing a bond a few years longer than the one that was sold.

In the following example, total taxes deductible were $2,275. Approximate trading cost; 1% or $350. (In this case the cost is absorbed by trading into a slightly longer maturity - you sold at $32,725; bought at $32,725.)

	Moody's Rating	Par Amount	Security	Coupon Rate	Maturity	Original Cost	Buy/Sell Price
YOU SELL	**Aa2**	**$35,000**	**Paramus, NJ**	**4.5%**	**16yr 3 mo**	**$35,000**	**$32,725**
YOU BUY	**Aa3**	**$35,000**	**Fort Lee, NJ**	**4.5%**	**18yr 3 mo**		**$32,725**

If you sell Paramus and buy Fort Lee, what have you accomplished? You still own an almost identical bond and you have gained a reduction in your taxes. This type of swap is easy to understand, and yet it is a very effective way to trade if you want to maintain the same type of bond portfolio.

If you're not satisfied that the type of bonds you own are best suited for your investment goals, it is possible when tax swapping to restructure your portfolio and create tax deductions in the process. Very often investors get into the municipal market without first considering their investment goals, learning about all of the various types of municipal bonds available, or matching the right bonds to their goals. Buying bonds that fit your financial needs is one of the most important things for a municipal bond investor to know. If you feel that you've started off on the wrong track, tax swapping can give you a second chance. Any Stoever Glass representative can assist you if you would like to consider restructuring you portfolio.

Helpful Tax Trading Tips

- Closed end bond funds and unit trusts can be traded either for other bond funds or for individual municipals. The reverse is also true. You can also trade municipals for unit trusts. Your Stoever Glass Account Executive can advise you as to which may be more suitable for you.

- To avoid having the IRS disallow your tax deductions under the "Wash Sale Rule" you should change at least two features between the bonds you sell and the bonds you buy. That is very simple to do, because all you have to do is change either the security and the maturity, or the security and the coupon rate.

- When attempting to swap bonds you must realize that trades can be done more efficiently during the year rather than later in the year since more time can be spent on each swap. As we approach year end, the volume of trades increases and the market becomes more hectic, making it more difficult to do swaps with maximum efficiency.

- If your bonds are held in safekeeping with another broker, they are obligated to act in accordance with your instructions. So don't let them try to force you into making a less beneficial trade through them just because they hold your bonds in safekeeping.

About Capital Gains and Losses

1) Long-term capital gains (investments held longer than one year) are taxed at a maximum 20% rate.
2) Short-term capital gains are taxed at the ordinary income rates.
3) Capital gains and losses must be netted out against each other before any capital losses can be applied to reduce ordinary income. This should be done in the following manner:

    a) short-term losses are deducted from short-term gains and a net figure results.
    b) long-term losses are deducted from long-term gains and a net figure results.
    c) there is a further netting if one group shows a loss and the other a gain.
    d) if there is a net short-term gain, it is taxable as ordinary income.

e) if there is a net long-term gain, it is taxable at a maximum 20% rate.
f) if there is a net long-term loss, then the first $3,000 is deductible from ordinary income.
g) if there is a net short-term loss it is carried forward.

4) It is possible to have both a net short-term gain as well as a net long-term gain or a net short-term loss and a net long-term loss. (In the case of two losses, they must retain their long-term or short-term nature when they are carried forward.)
5) Net long-term or short-term capital losses may be carried forward indefinitely, but only after you have taken your $3,000 ordinary income deduction.
6) Up to $3,000 of ordinary income may be offset by capital losses each year for single or joint returns. If filing married but separate, however, only $1,500 is permitted for each individual.
7) The rates and calculations mentioned above are subject to other rules when there are gains on collectibles, qualified small business stock, conversions of depreciable property, etc.

   A. The example provided is for illustrative purposes. There is no guarantee that the prices used in this example will be available since this article was produced in 2009.

Note: These were the applicable IRS rules as of June 10, 2009 when this article was written. However, IRS rules are always subject to change so be sure to consult your tax advisor and/or accountant with any further questions regarding capital gains or losses, prior to creating any “paper loss transactions.”

Although the above information and statistics are not guaranteed, they have been obtained from reliable sources and are believed to be accurate.