Tax Gain Harvesting on Fixed Income Positions

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The usual story around capital-gain harvesting is to take advantage of the zero-capital gains bracket (on income up to $39,750 per year) by selling some appreciated investments. This works for people with low to moderate income. However, the sharp decline in interest rates this year has created the opportunity to realize tax savings on appreciated fixed income positions even when clients are in a high tax bracket.

The strategy starts with the insight that when a bond increases in value it is an accelerated recognition of cash flows. The actual cash flows are unchanged. On a pretax basis, there is no economic difference between holding the appreciated bond to maturity or selling it and reinvesting the proceeds in a bond with the same yield, maturity date and risk.

This is not true on an after-tax basis.

Hypothetical example

Bond interest is taxed at ordinary tax rates. The gross return (payoff) after taxes on a bond purchased at par is:

$$R_{AT} = P\,(1 + C(1 - T_{ORD}))^{N}$$

where R_{AT} is the after-tax gross return, P the principal invested, C the coupon, T_{ORD} the ordinary tax rate and N the number of periods.

For example, assume an investor is in the 37% ordinary tax bracket and 20% capital gains bracket. When bought at par, a five-year, 5% bond with semi-annual coupon payments has an after-tax expected gross return of:

$$\$1{,}169 = \$1{,}000\,(1 + 0.025(1 - 0.37))^{10}$$

Say interest rates decline to 3% after the first year. At the beginning of the second year, using standard bond arithmetic, the (pre-tax) price of the bond is $1,075. If the bond is sold, the $75 gain is taxed at the long-term capital gains rate. This results in proceeds of $1,060. In addition, the investor has received two coupon payments, which, after taxes, total $32. Reinvesting the total in a new bond with a 3% coupon provides a gross return of:

$$\$1{,}177 = (\$1{,}060 + \$32)\,(1 + 0.015(1 - 0.37))^{8}$$

The decrease in market interest rates gives the investor an opportunity to have a portion of their income taxed at 20% instead of 37%.[1]

Real-world example

Consider an investor in the same tax brackets as before, who initiated a $50,000 position at the end of May 2019. She purchased the Vanguard Intermediate Term Treasury ETF (VGIT). The yield of the ETF was about 2%, which was the pre-tax return she could expect over the following six or so years (the average maturity of the bonds in VGIT). Holding the position for the full period, the expected after-tax gross return is, as before:

$$\$53{,}914 = \$50{,}000\,(1 + 0.01(1 - .37))^{12}$$

One year later, at the end of May 2020, VGIT had price appreciation of 7.8% and a total return of 10.1%, resulting in an unrealized gain of $3,900, plus about $1,170 of monthly taxable interest distribution. The estimated yield for the remaining time horizon of the investor declined to about 0.3%.

Assuming she reinvested income received but liquidated shares to pay the taxes, her basis is now $50,000 + $1,170 (1-

.37) = $50,737.

If she sells the position, she has an after-tax gain of $3,120 and total proceeds of $53,857. (For simplicity, I am ignoring additional gains on the monthly interest distributions.) When reinvested, this provides her with an expected gross return of:

$54,368 = $53,857 (1 + .0015(1 - .37))^{10}

By opportunistically realizing the gain on her holdings she was able to reduce taxes on her expected income.

Other considerations

The gain-recognition strategy is nothing new, but it is timely because it is inherently opportunistic. The benefit accrues regardless of whether interest rates increase or decrease in the future. Further decreases may present the opportunity to repeat the exercise and crystallize additional tax benefits. If rates increase, the market value of the new bonds will drop; however, once again this is a timing issue – the underlying cash flows are unchanged. Indeed, depending on the client's tax position this may represent an opportunity for subsequent tax *loss* harvesting and sheltering gains elsewhere in the portfolio.

As demonstrated, the strategy can be executed with funds and ETFs, though it is more efficient with individual bonds. The reason is that funds do not turn over portfolios to reduce future taxable interest when rates drop. For example, VGIT continues to have a distribution yield of over 1.5%, which will decrease only gradually as the portfolio turns over. Ironically, funds may be hesitant to recognize gains in the name of "tax efficiency." In addition, to the degree that funds do sell bonds, the gains are flushed out through annual required distributions, which may not reflect optimal timing.

The gain-recognition strategy provides added ammunition for those who argue for bonds in taxable accounts when rates are low. It also highlights one benefit of using mark-to-market fixed income instruments instead of accrual-based retail certificates of deposit.

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[1] If the investor continues to hold the bond to maturity, reinvestment in years two to five is at the lower market rate and the gross return is $1,164.

