Fixed-income investors often use bond swaps to more efficiently manage bond portfolios. You can use the strategy to alter one or more characteristics of a bond portfolio: income stream, credit quality, average maturity or call protection. And, if the market value of your bond is less than its cost, you might realize tax savings with a bond swap.

A bond swap is the term for selling bonds you currently own and using the proceeds from the sale to purchase other bonds. For example, if you anticipate higher interest rates, you might consider selling your long-term bonds and moving into shorter-term maturities that would fluctuate less in price. Inversely, if you expect interest rates to head lower, swapping out of short-term bonds and into longer-term issues would allow you to lock in higher yields and possibly improve the total return performance of your bond portfolio.

**TYPES OF BOND SWAPS**

There are a number of reasons you might consider a bond swap. Here are some of the motivations:

- **Quality swaps** alter the overall credit quality of a fixed-income portfolio. You might change the credit quality from AAA-rated bonds to AA-rated bonds, for example.

- **Yield (maturity) swaps** change the yield and maturities of the bonds in your portfolio. If you are seeking to raise your overall yield, you might sell bonds with shorter maturities and purchase longer-term bonds. Bonds with longer maturities generally yield more than shorter maturity bonds.

- **Product swaps** modify the type of bonds you hold. Treasury bonds, CDs, corporate bonds and municipal bonds are different sectors within the fixed-income markets, each with unique characteristics and yields.

- **Portfolio structure swaps** change the makeup of the portfolio. Swaps can be used to increase the number of bonds within a portfolio, enhancing diversification. Altering the number of callable bonds or swapping bonds with varying levels of call protection are also examples of portfolio structure swaps. For example, during periods of declining interest rates, you might minimize reinvestment risk by swapping out of callable bonds (those that can be fully repaid at any time) and buying non-callable bonds. The opposite is true during periods of rising rates.

- **Tax swaps** deliver valuable tax benefits. If the value of a bond in your portfolio is less than its cost, you may sell the bond and use the capital loss to offset capital gains elsewhere in your portfolio. Tax laws allow you to offset capital gains dollar for dollar, as well as up to $3,000 of ordinary income each year. Losses that are unused in one year may be carried forward to future years indefinitely.

**TAX CONSIDERATIONS**

There are several important rules to consider when evaluating the benefits of a bond swap. Always seek the advice of your tax advisor to determine the tax effect that a bond swap would have on your situation. The following rules and information should be reviewed in determining the value of a tax swap of bonds:

- **Wash sale rules**

  Generally, the wash sale rules disallow a loss on the sale of a security if “substantially identical” securities are purchased within 30 days before or after the date of sale. For tax purposes, the trade date is the determinative date for sales and purchases. Whether securities are “substantially identical” depends on the facts and circumstances in each case. Generally securities are not similar if issued by different entities. For example, bonds issued by Ford would be considered different than those issued by Chrysler. If the securities have the same issuer, factors that are considered in determining similarity include coupon rates, maturity dates, and other material features.

- **Market discount considerations**

  Additional considerations of a bond swap transaction is the market discount rules. If a bond is purchased in the secondary market at a discount to (less than) par, the amount of discount may be treated as ordinary income upon sale or redemption of the bond. Again, it is important to discuss the tax implications of any bond swap with your tax advisor.

Continued...
Current vs. long-term capital gains tax rates
You should be aware of the significant differences in the tax treatment of short-term capital gains and losses and long-term capital gains and losses.

- If an asset has been held for one year or less, gains and losses are short-term. Long-term gains and losses apply to assets held for more than one year.
- Short-term gains are taxed at ordinary income rates. Long-term gains receive preferential tax treatment: They are taxed at a maximum rate of 15 percent (unless the 5 percent rate applies**).
- You may offset short-term gains with long-term losses (or vice versa). If the final net gain is short-term, it is taxed at ordinary rates; if the final net gain is long-term, it is taxed at 15 percent (unless the 5 percent rate applies).

Remember, excess losses may be carried into future years indefinitely if you do not use them to offset gains or ordinary income in the current year. The short-term or long-term character of the losses are retained, and short-term losses are always used first.

CALL FOR A FREE BOND SWAP ANALYSIS
Well-executed bond swaps can help you positively rebalance your fixed-income portfolio to take advantage of changing market conditions and investment objectives. Your Piper Jaffray financial advisor will work with our fixed-income trading desks to provide you with a bond swap analysis. In addition to showing any potential tax savings, this analysis will evaluate the benefits of the bond swap in terms of:

- Income
- Average rating
- Par value
- Profit or loss
- Average maturity
- Cash outcome
- Yield

Bond swaps are a useful tool in the active management of a fixed income portfolio. Keep in mind that the tax swap season ends at the close of the calendar year and the pressures of supply and demand typically grow towards year-end.

*A 28 percent rate applies to long-term gain on collectibles and IRC Section 1202 gains. 25% rate applies to “unrecaptured IRC Section 1250” gains. 
**The 5 percent rate applies if the gain, absent the capital gain classification, would have been subject to only the 15 percent ordinary income tax rate.