

Municipal Bond Swap

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Originally Published: September 30, 2006



David owns a \$50,000 municipal bond that he bought at face value less than a year ago. The bond has a 3% coupon rate. Because of rising interest rates, the bond is currently selling at 95, or \$47,500. If David sells the bond in 2006, he will recognize a \$2,500 capital loss. He can then invest the \$47,500 of proceeds in a new municipal bond paying interest at 4%. David's effective tax rate is 33%.

If David were to do this it would enable him to currently benefit from the \$2,500 decline in the bond's value. He has a short term capital loss, which is a tax savings of \$825 ($\$2,500 \times 33\%$) against his ordinary income. Although David would then have bonds that will pay \$2,500 less at maturity, he may more than offset this with the increase in current municipal bond income (\$1,800 per year with the new bond versus \$1,500 per year with the old bond) and the current tax savings from the capital loss.

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