Using Rising Interest Rates and Deferred Tax Assets to Enhance Tax-Efficiency

By Thomas J. Boczar, Esq., LL.M., CFA®, CPWA®, and Elizabeth Ostrander, CFA®

Since the fourth quarter of 2015, the U.S. Federal Reserve has increased the federal funds rate by 100 basis points, and interest rates have risen along the yield curve since the presidential election in November 2016. There are, of course, many reasons why a sustained rise in U.S. interest rates may not occur, or occur as quickly and substantially as some expect, but many investors and economists believe that the long-anticipated normalization of the U.S. Treasury yield curve has begun.

A number of investors also find themselves in possession of large deferred tax assets, such as capital loss and/or charitable deduction carryforwards that may not be utilized for years, and which could expire worthless.

Despite the strong performance of the stock market in recent years, some individual investors have incurred large capital losses that are now nondeductible. For individual investors, capital losses are deductible only to the extent of capital gains, plus up to a maximum of $3,000 per year of ordinary income.1 If an individual is unable to generate sufficient capital gains to fully utilize capital losses, the losses can be carried forward indefinitely until death, at which point the losses expire worthless.2

In a similar vein, some individuals have donated property to charity in a manner that qualifies them for a charitable deduction. However, the charitable deduction for any tax year is limited to a percentage of the individual’s “contribution base,” which is the individual’s adjusted gross income (AGI) computed without regard to any net operating loss carryback.3 This percentage limitation is determined by both the type of organization receiving the donation and type of property donated.4 The percentage limitation is either 50 percent, or 30 percent for “capital gain property.”5 Any amount in excess of the percentage limitation for any tax year can be carried forward for a period of five years or until death, at which point those losses expire worthless.6 Unfortunately, some individuals who have donated property to charity are not able to generate sufficient AGI such that the percentage limitation will cause the potential deduction to expire worthless.

Investors in this position, who have large capital loss and/or charitable deduction carryforwards, and are of the view that interest rates in the United States are likely to continue to rise, can employ a strategy to economically benefit from the normalization of the yield curve and accelerate the deductibility of their deferred tax assets that otherwise are expected to expire worthless.

Individuals Can Prevent Charitable Deductions from Expiring Worthless

Consider the following example: Michael, an individual investor and taxpayer, contributed $10 million of highly appreciated shares to a donor-advised fund a little more than three years ago. Because the contribution consisted of qualified appreciated stock, he was entitled to a deduction equal to the fair market value of the property contributed, up to 30 percent of his AGI. Given his AGI that year, he was able to deduct only about $1 million. Carrying forward the remaining $9 million portion of his charitable deduction that he was unable to utilize that year ($10 million contribution – $1 million deducted) he was able to deduct an additional $4 million over the course of the subsequent three years (constrained, each year, by that 30-percent limitation). With two years left to utilize the remaining $5 million, and no expectation of generating sufficient AGI to do so, Michael expects the majority of this remaining charitable contribution carryforward to expire.

Michael would like to satisfy two key objectives. First, he is of the view that interest rates in the United States will continue to rise, and he’d like to profit from the normalization of the yield curve. Second, he realizes that his charitable contribution carryforward is a potentially valuable tax asset, and he wishes to explore how he might accelerate the utilization of that asset before it expires in two years.

Possible Capital Markets Solution

Michael met with his tax and investment advisors to research how he might satisfy both his investment objective (i.e., take advantage of rising interest rates) and tax objective (i.e., utilizing his charitable contribution deduction before its expiration). Michael and his advisors identified and vetted many tools he could use to profit from rising interest rates such as exchange-traded funds, Treasury inflation-protected securities, options, forwards, futures, and swaps, among many others. A comparative analysis revealed that, although each of these tools can deliver the desired protection against rising interest rates, each can produce very different tax consequences for
Michael; only one solution will allow Michael to potentially satisfy his investment and tax objectives simultaneously.

That said, it was decided that the most favorable strategy was for Michael to establish a short position in U.S. Treasuries (UST) with a fairly short maturity of approximately 18–24 months.

By doing so, with interest rates still near historic lows, Michael’s worst-case scenario could be defined with a fair degree of precision, and his maximum potential loss would be limited. Said another way, this maturity length enables Michael to benefit from what is effectively free put protection currently being offered by the market.

Here’s why: In a worst-case scenario (i.e., interest rates plummet), an investor who establishes a short position in two-year UST can simply keep the short position open until just before maturity of the UST. In that event, assuming the yield-to-maturity (YTM) on the UST is 1 percent on the date the short position is established, the investor would be required to pay the YTM of the bond for two years (i.e., a total of 2 percent of the principal amount of the bonds shorted). During this period, the investor will earn interest on the short sale proceeds and cash margin held by the bond dealer. Therefore, the investor’s maximum loss is 2 percent of the principal amount of the USTs shorted less the amount of interest earned on the short sale proceeds and cash margin held with the dealer.

In addition, USTs with a maturity of approximately two years are the most price sensitive to the market’s expectations regarding the Fed’s intention to raise the federal funds target rate. In the event that interest rates do continue to normalize as Michael expects, he’ll be in a position to benefit handsomely.

Tax Implications
This strategy is intriguing to Michael and his advisors for another reason: his otherwise nondeductible charitable deduction carryforward. Given current interest-rate levels, establishing a short position in a two-year UST will generate both capital gain (i.e., “above the line” income that increases AGI) and net investment interest expense (i.e., “below the line” deduction). Therefore, if structured properly, the strategy enables an investor to benefit from rising interest rates and accelerates the utilization of otherwise nondeductible charitable deduction carryovers by increasing the contribution base and thereby overcoming the percentage limitations.

Here’s how: Interest rates in the United States are near historic lows, but many U.S. Treasury bonds were issued many years ago when interest rates were much higher. These seasoned bonds, often referred to as “off-the-run” bonds, trade at a significant premium over par because today’s interest rates are significantly lower than when the bonds were issued.

By shorting bonds that currently are trading at a significant premium to par, the investor...
generates both capital gain (i.e., as rates begin to rise and the bond is "pulled to par") and interest expense (i.e., as the investor makes the "in lieu of" coupon payments to the lender of the bond). The gain generated on the closing out of the short UST position is short-term capital gain,7 and the "in lieu of" coupon payments are treated as investment interest expense,8 which for an individual investor is deductible without limitation against investment income. Investment income includes short-term capital gains and any type of taxable interest income, as well as certain other types of portfolio income, such as dividends and certain types of royalty income. This deduction doesn’t reduce AGI. Rather, it is subtracted from AGI to compute taxable income.

Therefore, the short-term capital gain generated by closing out the short position will increase Michael’s AGI, enabling him to utilize his charitable deduction, and the interest expense generated by the strategy will be deductible against the short-term capital gain generated by the transaction.

Michael decided to implement this strategy. He established a short position in a UST with a two-year maturity that was executed through a primary U.S. government bond dealer on exactly the same pricing, terms, and conditions that were then available in the marketplace to any sophisticated institutional investor. Michael entered into this strategy with the belief that the one-year U.S. Treasury rate was likely to rise significantly during the next 12 months.

The short position was closed out one year later, Michael’s view on rates was correct, and the results were attractive. As stated above, Michael had a $5-million charitable deduction carryforward. His AGI that year without the transaction was $5 million. The UST short sale transaction generated $12.5 million of short-term capital gain and $12 million of net interest expense, resulting in a profit of $500,000. The $12.5 million capital gain increased Michael’s AGI or contribution base to $17.5 million, allowing Michael to fully utilize his $5-million charitable deduction carryforward ($17.5 million × 30% = $5.25 million). The $12 million of net interest expense was deductible against $12 million of short-term capital gain generated by closing out the short position.

Michael earned a $500,000 profit on a cash investment of $2 million (i.e., the cash margin typically required for a transaction of this size and maturity) to generate a 25-percent pre-tax return, and an even greater after-tax return due to the utilization of his charitable deduction carryforward. The implementation of this strategy generated an attractive return and afforded him the opportunity to accelerate the utilization of his charitable deduction carryforward before it expired worthless.

In sum, individual investors such as Michael could find the strategy of shorting fairly short-maturity USTs appealing if they believe that the level of short-term interest rates, currently near historical lows, is not sustainable (i.e., he expects interest rates to continue to rise); and 2. possess charitable deductions that are nondeductible and in danger of possibly expiring worthless (after five years or upon death).

The strategy of shorting USTs also might be attractive to elderly, tax-sensitive investors who have otherwise nondeductible capital loss carryovers in danger of expiring upon their death, assuming they are of the view that interest rates will continue to rise. Given current interest-rate levels, as discussed above, the strategy will generate both capital gain and net investment interest expense. Therefore, if structured properly, the strategy enables an investor to benefit from rising interest rates and accelerates the utilization of otherwise nondeductible capital loss carryovers. It effectively converts otherwise nondeductible capital loss carryforwards into deductible interest expense.

Corporations Can Prevent Capital Losses from Expiring Worthless
A subchapter C corporation that has incurred a nondeductible capital loss also might find the strategy of shorting USTs attractive, assuming senior management is of the view that interest rates will continue to rise. Many public companies, which are usually C corporations for tax purposes, have realized substantial capital losses. For C corporations, capital losses are deductible only against capital gains.9 If a corporation is not able to generate capital gains, the capital losses can be carried forward for five years at which point such losses will expire worthless.10

Unfortunately, senior management of companies that have incurred capital losses often does not anticipate being able to generate sufficient capital gains to fully utilize the company’s losses; therefore, management often takes a valuation allowance against those losses, meaning they believe it is more likely than not that the losses will expire worthless after five years.

The strategy of shorting USTs gives a C corporation the ability to benefit from an anticipated normalization of the yield curve and effectively convert nondeductible capital losses into net interest expense, which is deductible against the corporation’s ordinary income, resulting in a 35-percent tax benefit.

Besides positioning the C corporation to better protect against inflation and the deleterious effects of rising rates, the strategy helps management to accomplish two important objectives. First, it enables management to satisfy its corporate governance obligations. Sound corporate governance policy and best practices recognize that management has a duty to prudently manage a company’s balance sheet, including determining if deferred tax assets can be utilized in the interests of shareholders, creditors, and other stakeholders. Second, it assists management in its efforts to maximize the value of the company’s stock price. If a company is able to utilize its deferred tax assets and thereby increase its after-tax cash flow, via the transmission of this information through the investor relations function to the investment community, management should help contribute to the company’s

Continued on page 47
ENDIANCE TAX-EFFICIENCY
Continued from page 24

securities achieving fair (higher) value in the market.

Summary
For individual and corporate investors who are of the view that interest rates will continue to rise, the strategy of establishing a short position in U.S. Treasuries with a fairly short maturity can be employed to benefit from increasing interest rates in a risk-controlled fashion and accelerate the deductibility of valuable tax attributes such as capital loss and charitable deduction carryforwards that might otherwise expire worthless.

Thomas J. Boczar, Esq., LL.M., CFA®, CPWA®, is chief executive officer of Intelligent Edge Advisors. He earned an LL.M. in taxation from New York University School of Law and a JD, an MBA, and a master’s degree in professional accounting from the University of Miami. Contact him at tboczar@intelligent-edge.com.

Endnotes
1. Internal Revenue Code (IRC) Section 1211(b).
2. Rev. Rul. 74-175.
3. IRC Section 170(b)(1)(G).
4. IRC Section 170(b)(1).
5. IRC Section 170(b)(1)(A), (B), and (F).
6. IRC Section 170(d); T.C. Memo, 1997-293; Regs. Sec. 1.170A-10(d)(4)(i).
7. IRC Section 1233.
9. IRC Section 1211(a).
10. IRC Section 1212(a)(1)(B).