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Abstract:

Tax considerations governing bondholders' optimal trading include: capital loss realization; capital gain deferment; change of the long-term holding period status to short-term by sale of the bond and repurchase, to realize future losses short-term; raising the basis above par by sale of the bond and repurchase, to deduct the amortized premium from ordinary income. The optimal policy which incorporates transactions costs and conforms to the IRS code substantially differs from the buy-and-hold and continuous-realization policies. Failure to account for optimal trading may seriously bias econometric estimation of the yield curve and the tax bracket of the marginal bondholders.

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