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RBC's planned autocall contingent coupon notes on Ford, GM may pay higher yield for longer

JPMorgan's floaters with step up tied to Libor seen as potential 1042 tax-free rollover play

JPMorgan's floaters with step up tied to Libor seen as potential 1042 tax-free rollover play

By Emma Trincal

New York, May 12 – A floating-rate note planned by JPMorgan's issuing arm intrigued market participants for the bond's low yield, very long duration and investor-friendly put options. One bond trader said the product was most likely designed to fit a little-known tax deferral strategy under the Section 1042 of the Internal Revenue Code.

JPMorgan Chase Financial Co. LLC plans to sell floating-rate notes due May 20, 2052 linked to Libor, according to a 424B2 filing with the Securities and Exchange Commission.

The notes will be guaranteed by **JPMorgan Chase & Co.**

Initially the notes will pay interest at a rate of Libor multiplied by 0.66 minus 40 basis points.

From May 22, 2020 the rate will step up to Libor minus 40 bps.

Staring on May 22, 2037, the rate will be Libor.

The coupon has a floor of zero.

Holders can put the notes to JPMorgan annually starting May 22, 2020 at 98% of par, at 99% of par from 2027 and at par from 2037.

Low rate

A financial adviser who buys structured products on a regular basis said he did not like the coupon and the length of the notes.

"I'm not a fixed-income guy but I do buy notes and this one makes absolutely no sense to me," he said.

"Why would you want to hold something like that for 40 years and take a 40 bps haircut?

"Rates are already low enough. I don't get this note at all."

A bond trader, who specializes in structured notes, had an explanation.

"As far as income is concerned there's no appeal at all," he said.

"But you can put the bond back and if rates go up, it might be advantageous."

Despite a repurchase price lower than par, at least for the first 20 years, note holders may not be penalized much if interest rates go higher.

Value in the put

The put price helped stabilize the value of the bond. In a bond selloff, investors would benefit from the put option, which would cushion them against losses on the secondary market, he said.

"This bond you can put back at 98. It's less than par, but it may be better than what's out there in the market depending on how much interest rates have gone up," he said.

"You're selling the bond at 98. But the bond could be worth 90!"

For this trader the put was the most valuable piece of the structure.

"Put options on a bond are very, very unusual. You're not going to find it very often.

"The issuer cannot call it. You can hold it. You can put it. You're in control.

"The coupon is very unattractive because you have a put option against a higher interest rate environment."

1042 tax-free roll

This trader made another assumption: the notes could be used by tax-savvy investors under section 1042 of the IRS code.

A business owner can elect to use section 1042 to sell their company stock to an employee stock ownership plan (ESOP) in order to defer taxes on capital gains on the sale under certain requirements. One of them is the obligation for the seller to roll over the proceeds in a so-called

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"qualified replacement property" or QRP.

"The characteristics of this note are very similar to what we used to do with ESOP," the trader said.

"You own a company. You have an ESOP. You sell 30% to your employees; you put the proceeds into a qualified replacement property, which would be this bond. As long as you put the proceeds in a QRP you don't have to pay taxes.

Qualified replacement property

A consultant at an investment bank, which specializes in structuring ESOP transactions offered more details about QRPs.

"You need the bond in order to have a tax-free rollover. The 1042 requirement is that you reinvest the proceeds into U.S. company stocks and bonds," this consultant said.

QRPs can be stocks or bonds of issuers domiciled in the United States.

Government bonds, mutual funds, bank certificates of deposits and REITs are excluded from the definition.

The prospectus' "selected purchase considerations" stated that: "JPM, as issuer, is of the view that the notes should qualify as qualified replacement property."

Long, floating

The long-term duration of the notes is part of a tax-efficiency plan.

"You buy this 35-year bond for the same reason you would buy a long-term corporate bond: you don't want to mature or be called because you would have a tax event," the bond trader said.

But the variable coupon was an ever clearer signal that the notes could be used for the tax-efficient rollover strategy.

"Floating-rate notes are some of the most prevalent 1042 QRPs in today's market," said Doug Pugliese, director of portfolio services at advisory firm Alpha Architect, in a white paper he wrote on the subject.

That's partly because floaters are deemed more stable in value. As such they can often be used as collateral for borrowings.

"A floating-rate bond helps ensure that the principal amount will remain the same," the investment bank consultant said.

This is because the variable coupon is pegged to the market, which significantly reduces interest rate risk.

"If rates go up, the value of the bond won't go down as much because the coupon absorbs some of the decline," noted the trader.

Pugliese explained that "floating-rate notes are used almost invariably as the first piece of a complex strategy to borrow against the QRP in order to monetize the wealth that is tied up in the property."

In this context, the JPMorgan deal fits the profile of the strategy offering most of the characteristics of an "ESOP bond," according to the trader.

"People buy it for a 1042 rollover because of the long-term duration," he said.

"The reason you have a floater is to decrease the volatility. Remember, people borrow against these bonds. You don't want something that goes down a lot and gives you a margin call.

Finally the put also kept the price stable.

"If bonds drop in price, this one will stay close to the put price. It won't go down. Somebody on the secondary market can always buy it at that price."

Death put

From a tax perspective, exercising the put would not be helpful to the ESOP rollover strategy, the consultant said.

"The put doesn't help. As soon as you put the bond you will be taxed on the full amount of the capital gain unless you have died," she said.

"The value of the put is really limited to the event of death. When you die you need to be able to sell the bond back to the issuer, get the proceeds and your heir can benefit from a stepped up basis so that way the value of the proceeds from the sale to the ESOP is never taxed."

J.P. Morgan is the agent.

The notes will price on May 15 and settle on May 22.

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