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A Guide to Fixed-Income Investing

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4. Taxation of Fixed-Income Returns

Bond returns come primarily from interest income and capital gains. Let's look at how they are taxed.

a. Interest Income

Bond coupons are taxed at the full ordinary income tax rate.

b. Capital Gains/Losses

In Canada, bond capital gains are taxed at the capital gains income tax rate, with the 50% inclusion factor. Capital gains can arise from two sources. First, a decline in the market yield will trigger a price increase. Second, a bond purchased at a discount will converge toward its par value as it seasons, since its final principal payment is $100. Conversely, a capital loss can occur either after an increase in yield or if the bond was purchased at a premium.

c. After-Tax Yield to Maturity

When a bond is purchased at a discount, there will be a taxable capital gain if held to maturity, even without a decline in bond yields. By contrast, when a bond is purchased at a premium, there will be a tax loss at maturity, which could be applied against existing or future capital gains on other positions in the portfolio.

The after-tax yield to maturity on a bond is calculated in two steps: first, the expected tax cost will be removed from bond cash flows (after-tax coupon and principal repayment), and second, a yield-to maturity calculation is applied to the after-tax cash flows.

Of course, the after-tax yield is also a function of the investor's marginal tax rate. For an investor with a very low tax rate, the after-tax yield will not be far below the yield to maturity. By contrast, an investor with a high tax rate will obtain an after-tax yield that is much lower than the yield to maturity. Table 3 provides a simple example of after-tax yield calculation for a discount bond with a one-year maturity. At 1.87%, the after-tax yield is a little bit more than half the pre-tax yield to maturity of 3.03%.

Table 3: After-tax yield on a 1-year bond with a 2% coupon priced at $99, with a 46% marginal tax rate

After-tax coupon: 2% X $100 X (100%-46%) = $1.08

After-tax capital gain: ($100-$99) X (100%-(46%/2) = $0.77

Invested capital: $99

After-tax yield: $1.08 + $0.77 / $99 = 1.87%

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