The After-Tax Advantage of Discount Bonds

BMO Nesbitt Burns | July 2023

With the highest interest rates seen in over a decade, GICs have become extremely popular among yield-focused investors looking for limited – to no – portfolio volatility. However, bond yields have also increased significantly, leading to many securities now being offered at deeply discounted values to their maturity value (i.e., $100)[1]. As a result, the fixed income market may actually offer a more attractive investment opportunity than GICs for investors from a tax perspective.

The advantage of buying a bond at a discount is that a portion of the future return will come from price appreciation (the difference between the discounted price and the maturity value of $100), which is treated as a capital gain. Considering the capital gains inclusion rate of 50%, this means that half the capital gain is tax-free while the other 50% is added to the coupon income and taxed as regular income. 100% of the return of a GIC comes from interest income and is taxed as regular income (~53% for the top tax bracket).

For example:

- A bond with two years to maturity is purchased in the secondary market at a price of $96.17 and a coupon rate of 3.224%
- After two years:
    - $3.83 will be realized as a capital gain ($100 – $96.17)
    - $6.45 is received as interest income
    - The total pre-tax return is $10.28 ($6.45 + $3.83)
- Of the total return, $8.365 will be taxed as regular income:
    - $3.83 x 50% (inclusion rate for capital gains) + $6.45 interest income
- If the investor's tax rate is 53%, the after-tax return is $5.846:
    - $8.365 x 47% + $1.915 (non-taxable portion of the capital gain from the 50% inclusion)
- The cumulative two-year after-tax return would be 6.08% ($5.846 / $0.9617)
- The annualized after-tax return would be 2.99%: ((1+.0608)^(1/2 years)-1)

To earn the same after-tax return on a GIC, the GIC rate would have to be 6.36%, more than twice the return of the bond: 6.36% x (1 - 53% tax rate) = 2.99% after-tax return.

The lower the price of the bond, the higher the GIC rate needs to be to earn the equivalent after-tax return.

To provide further perspective, **Figure 1** examines the various after-tax yields on select government and corporate bonds compared to GICs of similar terms.

[1]Yields and bond prices are inversely related. So, a rise in a bond price will **decrease the yield; and a fall in the bond price will increase the yield**.

Figure 1: Select Discount Bonds

Bond	Bond After Tax Yield	GIC F-Class After Tax Yield	GIC F-Class
VW 2.05% 10 Dec 2024	3.71%	2.63%	1-year BMO GIC @ 5.60%
Saskatchewan 0.80% 2 Sep 2025	3.24%	2.59%	2-year BMO GIC @ 5.50%
BMO FF2030 2.077% 17 Jun 2025	3.74%	2.59%	2-year BMO GIC @ 5.50%
Honda 1.337% 17 Mar 2026	3.49%	2.52%	3-year BMO GIC @ 5.37%
SunLife FF2032 2.58% 10 May 2027	3.31%	2.44%	4-year BMO GIC @ 5.19%
Ontario 1.05% 08 Sep 2027	2.75%	2.44%	4-year BMO GIC @ 5.19%
RY FF2033 1.67% 28 Jan 2028	3.70%	2.46%	5-year BMO GIC @ 5.23%

Source: BMO Nesbitt Burns Portfolio Services Group

For investors looking to invest over $100,000, government bonds can offer a similar return to GICs while upgrading the quality of the portfolio. Further, the capital gain on the bond is only taxable when it is sold or has matured, providing a tax deferral advantage until maturity. For example, if a bond that matures in January 2024 is purchased today and held to maturity, the tax on the capital gain wouldn't be due until the investor files their 2024 income tax return in 2025.

It is important to note that GICs remain an attractive option for tax-exempt investors, as well as individuals who prefer the $100,000 Canada Deposit Insurance Corporation ("CDIC") coverage that they provide.

Please speak with your BMO Private Wealth professional for further information and to discuss whether discounted bonds are right for your investment strategy.

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