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FINANCIAL ADVISORY SUPPORT

Bonds: The Tax Implications

Your ACB on Purchase and the Tax Implications When you Sell Bonds

The following article provides an overview of bonds that pay regular interest. Determining the Adjusted Cost Base (ACB), defining what premiums and discounts are and explaining how to calculate and report a capital gain or loss on the sale of a bond are discussed.

Bonds that Pay Regular Interest

A bond is a debt instrument that pays interest at a set rate at regular intervals such as monthly, semi-annually or annually. The stated interest rate, at the time of issue of the bond, is usually close to the current interest rate in the market. The principal amount of the bond, when issued, is known as the "face value". The price of the bond is expressed as a percentage of its face value and is affected by the stated interest rate on the bond relative to the current price in the market. The price of a bond, at issue, will usually equal its face value which is also known as "par". Interest payments received are to be reported on your annual tax return and will be included on your T5 slip. Residents of Québec will also receive a Relevé 3 to report the interest paid.

Buying A Bond

When you buy a bond on its issue date, you will typically pay the same amount as the bond's stated face value. Most bonds will be bought on the secondary market.

THE EFFECT OF REGULAR INTEREST PAYMENTS ON THE PRICE YOU PAY

If you buy a bond on a date other than the date an interest payment is paid, the price you pay will likely contain an amount of accrued interest. This amount will show up on the year end tax reports that come with your tax slips (but will not appear on the tax slips themselves) as an amount "Paid By You" that can be deducted as an expense on schedule 4 of your personal Canadian tax return.

The amount you pay for interest is the amount the person selling the bond to you receives for the interest accrued to them while they held the bond from the last scheduled payment date. Another way of looking at it is that you will receive the full amount of the regularly scheduled payment on the next payment date but you only held a bond for a portion of the time covered by the payment. You need to pay the person who held the bond before you for the amount of interest that they earned while holding the bond.

For example:

You purchase a $100,000 face value bond at par paying 6% interest on January 31. Maturity date of the bond is December 31 and interest is paid semi annually. This means the regular interest payment dates are June 30 and December 31. Since you bought it from someone else in between payment periods, you will receive the full semi-annual payment of $3,000. This means that you should pay interest to the person you bought the bond from for the 30 days that they held the bond. The amount of interest equals $493.15 (30days/365days x 6% x $100,000). The price you paid to purchase the bond will include the $493.15 interest and it will show on your year end T5 summary as an amount "Paid by You".

THE EFFECTS OF INTEREST RATES ON THE PRICE YOU PAY

After issue, a bond can be bought or sold on the secondary market. If the market interest rate drops after issue, you may find that your bond is paying more than the current rate. This makes your bond more valuable, causing it to trade at a premium (i.e.: a percentage of more than par or more than 100%). Conversely, if interest rates rise after issue, you may end up holding a bond that is paying less than the current rate and potential purchasers will only buy your bond at a discount (i.e.: a percentage of less than par or less than 100%).

Continuing our example:

If on January 31, the current interest rate dropped to 5.5%, potential buyers would probably offer you a premium price for your bond as your bond pays more interest than similar available bonds.
If on January 31, the current interest rate rose to 6.5%, potential buyers would probably require a discounted price for your bond as your bond pays less interest than similar available bonds.

Maturing at Par

When you hold a bond that pays regular interest and it matures at par, the difference between the par value at maturity and your adjusted cost base (ACB) is considered a capital gain or capital loss for tax purposes. If you originally purchased the bond at a discount, you will have a capital gain upon maturity. If you originally purchased the bond at a premium, the difference between the par value at maturity and your purchase price will be considered a capital loss.

Generally your ACB is your original purchase price for the bond. Keep in mind that if you had originally purchased the bond between coupon dates, your original purchase price may have included an amount for the accrued interest which you had to pay to the seller of the bond. This amount should have been deducted on your tax return in the year of purchase as interest paid and does not form part of your ACB.

Your Book Value reported on your monthly investment account statements will exclude any amount you paid for accrued interest if you purchased the security at Dominion Securities or Direct Investing. If a bond was transferred into Dominion Securities or Direct Investing, the book value could contain an amount for accrued interest.

Selling Prior to Maturity

When you sell a bond that pays regular interest between coupon dates, the proceeds you receive from the purchaser will include accrued interest income paid to you by the purchaser for the interest you earned on the bond which has not yet been paid by the issuer. The interest income will be included in your T5. For residents of Québec, the interest income will also be reported on your Relevé 3.

The remaining portion of the sales proceeds you received for the sale of the bond is your “proceeds of disposition” for purposes of calculating your capital gain or loss on the sale. Your Summary of Securities Dispositions will report the proceeds of disposition net of the portion which is interest income.
If your sales proceeds net of accrued interest are greater than your adjusted cost base, you will have a capital gain. This often happens when interest rates have decreased since the bond was acquired. If your proceeds of disposition are less than your adjusted cost base, you will have a capital loss. This often happens when interest rates have increased since the bond was acquired.

An example of selling at a premium:

Assume you bought a $10,000 bond for 104 and because interest rates have gone up since your purchase, your bond is worth less because it pays less than what someone can get on the open market. Therefore, you are only able to sell your bond for 101 now. To make things easier, we will assume that the purchase and sale occur on a payment date so there is no accrued interest. This means you paid $10,400 for the bond and you will receive $10,100 upon a sale. Note that even though you sold at a premium, you still end up with a loss of $300 to report on your tax return.

An example of selling at a discount:

Assume you bought a $100,000 bond at par and because interest rates in the market have gone up since your purchase, this has caused your bond to be worth less because it pays less than what someone can get on the open market. Therefore, you are only able to sell your bond for 97 now. To make things easier, we will assume that both the purchase and sale occur on a payment date so there is no accrued interest. This means you paid $100,000 for the bond and you will receive $97,000 upon a sale. You will have to report a loss of $3,000 on your tax return.

Summary

The following table summarizes the different possible taxation outcomes you could have from selling a bond. Remember that your proceeds of disposition is equal to the sale price less any accrued interest that you receive from the purchaser

Table 1: Potential tax results from selling a bond paying regular interest

		Sell At Discount	Mature / Sell At Par	Sell At Premium
	Price	…, 97, 98, 99	100	101, 102, 103, ...
Buy At Discount	... 97 98 99	Capital Gain or Capital Loss	Capital Gain	Capital Gain
Buy At Par	100	Capital Loss	No Capital Gain Or Capital Loss	Capital Gain
Buy At Premium	101 102 103 …	Capital Loss	Capital Loss	Capital Gain or Capital Loss

It is important to understand the components that make up the amount you pay or receive for a bond as well as the concepts of a premium and discount. If you have any questions on how to report for tax purposes the proceeds you have received from the sale of a bond, it is recommended that you discuss this with your professional tax advisor.