

Premium Bonds: Tax Implications for Swiss Investors

This A&O article is relevant to Swiss investors. In Switzerland there is neither tax on capital gains, nor tax relief on capital losses. Most other jurisdictions differ.

By virtue of tax regulations, not all bonds with the same yield are equally beneficial to a Swiss-domiciled investor. Given the same pre-tax yield, higher-coupon and higher-priced bonds generate lower post-tax yields than lower-coupon and lower-priced bonds.

To illustrate, Table 1(a) below shows a 5-year bond with a coupon of 2.5% p.a. and price of 100%, generating a pre-tax yield of 2.5% and post-tax yields of 2.0% (at a 20% tax rate) and 1.75% (at a 30% tax rate). Table 1(b), however, shows a 5-year bond with a coupon of 4.0% p.a. and a price of 107% also generating a pre-tax yield of c.2.5% but a post-tax yield of only c.1.7% (at a 20% tax rate) and only c.1.3% (at a 30% tax rate).

Illustration (2): Buying a 5-year 1.0% coupon bond at 100% that rises to 103% two years later

Table 2(a) displays the resultant pre- and post-tax yields for a 1.0% p.a. 5-year bond while Table 2(b) displays the resultant yields of the same bond two years later (remaining bond life of 3-years).

Table 3(a): 5-Year Bond Life, 1% p.a. Coupon

Price =>	100	101	102	103	104	105	106	107
Gross Yield	1.00	0.80	0.59	0.39	0.20	0.00	-0.19	-0.38
Intuitive Net Yield (@20% Income Tax)	0.80	0.64	0.47	0.31	0.16	0.00	-0.15	-0.30
Actual Net Yield (@20% Income Tax)	0.80	0.60	0.39	0.19	0.00	-0.20	-0.39	-0.58
Intuitive Net Yield (@30% Income Tax)	0.70	0.56	0.41	0.27	0.14	0.00	-0.13	-0.27
Actual Net Yield (@30% Income Tax)	0.70	0.50	0.29	0.09	-0.10	-0.30	-0.49	-0.68

Table 3(b): 3-Year Bond Life, 1% p.a. Coupon

Price =>	100	101	102	103	104	105	106	107
Gross Yield	1.00	0.66	0.33	0.00	-0.32	-0.65	-0.96	-1.27
Intuitive Net Yield (@20% Income Tax)	0.80	0.53	0.26	0.00	-0.26	-0.52	-0.77	-1.02
Actual Net Yield (@20% Income Tax)	0.80	0.46	0.13	-0.20	-0.52	-0.85	-1.16	-1.47
Intuitive Net Yield (@30% Income Tax)	0.70	0.46	0.23	0.00	-0.22	-0.46	-0.67	-0.89
Actual Net Yield (@30% Income Tax)	0.70	0.36	0.03	-0.30	-0.62	-0.95	-1.26	-1.57

If an investor purchases a 5-year bond with 1.0% p.a. coupon at 100%, and the bond price gradually rises to 103% after two years, the bond will give rise to a pre-tax yield of 1.0% initially and a pre-tax yield of 0.0% after two years. An investor subject to a 20% income tax rate will receive a post-tax yield of 0.8% initially and a post-tax yield -0.2% two years later.

Opinion

Selling a bond before maturity at a price above cost and switching into another is generally unlikely to be a winning strategy for private investors. If the price of your bond has risen (resultant yield has declined) it is likely other bonds have risen similarly, driven by a general market movement in interest rates or credit spreads. Switching into another bond also involves paying two sets of commissions (once on selling the existing bond and once on the purchase side) and two sets of market-maker bid-ask spreads.

For Swiss investors, however, on a post-tax basis, the situation may be different. Investors may benefit post-tax from switching into a lower-priced bond of similar yield. Alternatively, simply selling the bond and placing the proceeds in a cash account earning 0% interest may be preferable to holding a bond with a negative post-tax yield.

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 Analysis & Opinion
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Table 1(a): 5-Year Bond Life, 2.5% p.a. Coupon

Price =>	100	101	102	103	104	105	106	107
Gross Yield	2.50	2.29	2.07	1.87	1.66	1.46	1.25	1.06
Intuitive Net Yield (@20% Income Tax)	2.00	1.83	1.66	1.50	1.33	1.17	1.00	0.85
Actual Net Yield (@20% Income Tax)	2.00	1.79	1.57	1.37	1.16	0.96	0.75	0.56
Intuitive Net Yield (@30% Income Tax)	1.75	1.60	1.45	1.31	1.16	1.02	0.88	0.74
Actual Net Yield (@30% Income Tax)	1.75	1.54	1.32	1.12	0.91	0.71	0.50	0.31

Table 1(b): 5-Year Bond Life, 4.0% p.a. Coupon

Price =>	100	101	102	103	104	105	106	107
Gross Yield	4.00	3.78	3.56	3.34	3.12	2.91	2.70	2.49
Intuitive Net Yield (@20% Income Tax)	3.20	3.02	2.85	2.67	2.50	2.33	2.16	1.99
Actual Net Yield (@20% Income Tax)	3.20	2.98	2.76	2.54	2.32	2.11	1.90	1.69
Intuitive Net Yield (@30% Income Tax)	2.80	2.65	2.49	2.34	2.18	2.04	1.89	1.74
Actual Net Yield (@30% Income Tax)	2.80	2.58	2.36	2.14	1.92	1.71	1.50	1.29

Most investors shy away from purchasing bonds trading significantly above par (par = price of 100%). This can be advantageous to Swiss investors. However, most also retain their bond positions to expiry, even when the bonds later trade at a large premium to par. In doing so, they miss the opportunity for a tax benefit – gaining from the tax-free capital gain and avoiding a “relief-free” capital loss.

Illustration (1): Buying a 5-year 2.5% coupon bond at 100% that rises to 106% two years later

To illustrate, Table 2(a) displays the resultant pre- and post-tax yields for a 2.5% p.a. 5-year bond while Table 2(b) displays the resultant yields of the same bond two years later (remaining bond life of 3-years).

Table 2(a): 5-Year Bond Life, 2.5% p.a. Coupon

Price =>	100	101	102	103	104	105	106	107
Gross Yield	2.50	2.29	2.07	1.87	1.66	1.46	1.25	1.06
Intuitive Net Yield (@20% Income Tax)	2.00	1.83	1.66	1.50	1.33	1.17	1.00	0.85
Actual Net Yield (@20% Income Tax)	2.00	1.79	1.57	1.37	1.16	0.96	0.75	0.56
Intuitive Net Yield (@30% Income Tax)	1.75	1.60	1.45	1.31	1.16	1.02	0.88	0.74
Actual Net Yield (@30% Income Tax)	1.75	1.54	1.32	1.12	0.91	0.71	0.50	0.31

Table 2(b): 3-Year Bond Life, 2.5% p.a. Coupon

Price =>	100	101	102	103	104	105	106	107
Gross Yield	2.50	2.15	1.81	1.47	1.14	0.81	0.48	0.16
Intuitive Net Yield (@20% Income Tax)	2.00	1.72	1.45	1.18	0.91	0.65	0.38	0.13
Actual Net Yield (@20% Income Tax)	2.00	1.65	1.31	0.97	0.64	0.31	-0.02	-0.34
Intuitive Net Yield (@30% Income Tax)	1.75	1.51	1.27	1.03	0.80	0.57	0.34	0.11
Actual Net Yield (@30% Income Tax)	1.75	1.40	1.06	0.72	0.39	0.06	-0.27	-0.59

If an investor purchases a 5-year bond with 2.5% p.a. coupon at 100%, and the bond price gradually rises to 106% after two years, the bond will give rise to a pre-tax yield of 2.5% initially and a pre-tax yield of 0.48% after two years. An investor subject to a 20% income tax rate, however, will receive a post-tax yield of 2.0% initially and a post-tax yield of -0.02% two years later.

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