Dr. Strangelove Unleashes the Secrets to a Certain Widely Held U.S. Debt Instrument: Or How I Learned to Stop Worrying and Love the Savings Bond

By Douglas H. Frazer

Douglas Frazer describes the types and rules of various U.S. Savings Bonds and suggests how to use and manage savings bonds effectively in an individual’s portfolio.

Introduction

Morton Kleinrocket was enamored with bonds. James Bond, Barry Bonds, Bond Jovi—it didn’t matter.

Kleinrocket particularly loved U.S. savings bonds—backed by the full faith and credit of the U.S. government. That sounded like something a cold warrior would appreciate. Kleinrocket was a conservative blue-collar investor. He worked two jobs most of his life. He loved his wife Portia, his kids Talya and Natalie, and safe investments. Kleinrocket particularly looked for investments that gave a better return than, say, a certificate of deposit or money market account.

Kleinrocket invested heavily in savings bonds. For a few years until the opportunity ended on December 31, 2003, Kleinrocket bought his bonds online with his affinity credit card and got free miles to boot.

Near the end (“Kleinrocket croaks,” he wanted the story to read), he had amassed $1.2 million in E, EE, HH and I bonds. Here was the picture:

- Series E. Face amount $125,000. Owner Morton Kleinrocket. No co-owner or beneficiary designated.
- Series EE. Face amount $135,000. Co-owners Morton Kleinrocket and Talya Kleinrocket.

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Savings Bonds


Series HH. Face amount $175,000. Owner Morton Kleinrocket and beneficiary Portia Kleinrocket.

Series I. Face amount $185,000. Owner Portia Kleinrocket and beneficiary Talya Kleinrocket.

Kleinrocket’s tax attorney, Strangelove, was left to sort out the tax consequences of these investments.

As can be seen, co-ownership of bonds is not effective for purposes of income splitting between contributing and noncontributing co-owners.

General Principles

Savings bonds are a common asset found in portfolios of all sizes. According to the Bureau of Public Debt, the division of the Treasury that sells and administers U.S. bonds, an estimated 55 million people hold over $200 billion worth of savings bonds.

Savings bonds in their modern form originated during World War I in the form of Liberty bonds. Later, America’s purchase of Series E bonds helped to finance World War II—even before the United States entered it. Treasury Secretary Henry Morgenthau sold the first Series E bond to president Franklin D. Roosevelt on May 1, 1941.

Savings bonds seem simple, but they are not. Presently, only Series EE and Series I may be purchased for cash. Savings bonds can be purchased at most banks, at many savings and loans, and online, in paperless electronic form, through TreasuryDirect. The Treasury issues Series EE bonds at a 50-percent discount from face value. (TreasuryDirect Series EE bonds are issued at face value.) The bonds can be purchased in denominations ranging from $50 to $10,000. The U.S. Treasury issued the predecessor bond, the Series E bond, prior to January 1, 1980, at 75 percent of face value. Series EE bonds issued on or after May 1, 1997, earn interest based on 90 percent of the average yield on five-year Treasury securities for the preceding six months. The bonds increase in value every month and the interest is compounded semi-annually. The interest rate is adjusted every six months, on May 1 and November 1.

A person can purchase up to $30,000 worth of paper EE bonds each calendar year. In addition, a person can purchase up to $30,000 in I bonds per calendar year through TreasuryDirect. The issue price of the I bond applies toward the annual purchases of the co-owner whose name and social security number appears on the bond. The purchase limit for I bonds is not affected by the purchases of EE bonds.

Investors who buy Series EE or Series I savings bonds can elect to defer taxation of the interest income until final maturity, redemption or disposition. Alternatively, investors can elect to report the increase in the redemption price from year to year. This election applies to all bonds that the taxpayer owns, as well as those acquired later. Upon application, the IRS may, however, grant permission for the election to be changed.

The election does not apply to a transferee of the taxpayer. The transferee is taxed on future increases under the deferral rule, unless the transferee elects otherwise.

Final maturity of Series EE or I bonds does not extend beyond 30 years. No interest accrues after the final maturity date.

Series HH bonds are available only in exchange for EE/E bonds (or upon reinvestment of matured HH/H bonds). Series HH bonds

Inflation-indexed Series I bonds earn interest based on a fixed rate set when the bond is purchased plus payments from a variable rate portion that changes twice a year based on the consumer price index measure of inflation. The bonds increase in value every month. At every semi-annual anniversary, the rates are locked in. Series I bonds are sold only at face value.

A person can purchase up to $30,000 worth of paper I bonds each calendar year. In addition, a person can purchase up to $30,000 in I bonds per calendar year through TreasuryDirect. The issue price of the I bond applies toward the annual purchases of the co-owner whose name and social security number appears on the bond. The purchase limit for I bonds is not affected by the purchases of EE bonds.

Investors who buy Series EE or Series I savings bonds can elect to defer taxation of the interest income until final maturity, redemption or disposition. Alternatively, investors can elect to report the increase in the redemption price from year to year. This election applies to all bonds that the taxpayer owns, as well as those acquired later. Upon application, the IRS may, however, grant permission for the election to be changed.

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Series HH bonds are available only in exchange for EE/E bonds (or upon reinvestment of matured HH/H bonds). Series HH bonds
pay interest every six months. Investors who buy Series HH bonds can likewise elect to defer taxation of interest income until final maturity, redemption or disposition. Final maturity does not extend beyond 20 years. The current interest rate is 1.5 percent. The initial interest rate stays the same for 10 years—then another rate is declared for the last 10 years.

Until August 31, 2004, Series EE/E bonds can, on or before one year (following) final maturity, be exchanged for Series HH bonds. After that date, the Treasury is discontinuing the sale of HH bonds.

Form of Ownership

U.S. savings bonds are registered securities. The name of the owner is printed on the face of the bond. Each type of bond is issued in the form of individual ownership or co-ownership. Strangelove liked to illustrate this principle using his cousins, Anton, Biff, Carl and Dick. Co-ownership takes the form of “Anton” or “Biff.” This means that for paper bonds the Treasury will pay either Anton or Biff on presentation of the bond. In TreasuryDirect, Biff may only cash the bond if Anton grants the right to do so. If either Anton or Biff dies, the survivor is the sole owner.

The first named co-owner normally is presumed to be the principal co-owner; i.e., the person who provided the consideration for the purchase of the bond. This presumption may be overcome if both parties on the bond confirm otherwise.

When bonds are registered in the co-ownership form, the entire value of the bond passes to the survivor. This rule is unrelated to the issue of who pays—or has paid—the income or estate taxes on the accrued interest. Thus, the rule applies even if all or part of the value of the bonds are deemed to belong to the decedent for estate tax purposes, or if the decedent’s estate pays income tax on the interest that has accrued until the date of death.

Bonds may also be issued with a beneficiary designation. Title would read “Anton” payable on death (POD) to “Carl.” This means that during Anton’s life the Treasury will pay only Anton, and on Anton’s death the government will pay only Carl. Anton (the owner) may substitute another beneficiary. Carl, therefore, has a contingent future interest. Carl is not required to redeem the bond upon Anton’s death.

The maximum number of names on a bond is two. This is the case regardless of the form of registration. Thus, the attempted simultaneous registration of Anton, Biff and Carl, is known in the tax world as bond-ménage interruptus.

U.S. citizens, residents, fiduciaries or entities may buy savings bonds. Bonds purchased by entities cannot have a co-owner or beneficiary listed on the bond. Similarly, an individual bond owner cannot list an entity as the co-owner or beneficiary on any type of savings bond. One exception exists. An individual may designate the United States as a co-owner or beneficiary. (It is not believed many people take advantage of this opportunity.)

The reissue of this designation is not permitted unless, in the case of Series EE or HH bonds, the United States has been listed as a beneficiary.

Registration of savings bonds in co-ownership form does not automatically confer a property interest. The courts consider the act of possession of the bonds and the contribution toward the purchase as factors in determining the respective property interest.

Thus, a court determined that a Biff (co-owner), who did not contribute to the purchase of the subject bonds, had exercised no possession or control over the bond and had no property interest in the bonds. The court concluded that Biff had nothing more than an inchoate interest in the bonds. This interest would have matured into a property interest in the bonds only if Anton (the principal co-owner) predeceased Biff.

Income Taxes

Since March 1, 1941, the interest on U.S. savings bonds has been subject to federal income tax, but is exempt from state, municipal or local income taxes. As mentioned earlier, investors who buy savings bonds can elect to defer taxation of the interest income until final maturity, redemption or disposition. Alternatively, investors can elect to report the increase in the redemption price from year to year.

The Taxpayer

The interest income (sometimes referred to as the appreciation or the increment in value) is taxable to Anton (the co-owner who furnished the consideration) even though Anton permits Biff (the other co-owner) to redeem the bond and retain the entire proceeds. If Biff surrenders the bond for re-registration solely in Biff’s name, Anton must pick up as income the appreciation from the date of issue to date of re-registration. Conversely, if the bond is reissued in the sole name of Anton, Anton need not include in the year of re-registration the appreciation from the date of issuance until the date of re-registration.
The person who redeems the bonds will be issued a Form 1099-INT. If the redeeming co-owner is also the noncontributing co-owner, the redeeming-noncontributing-co-owner (say that three times fast) is supposed to issue to the nonredeeming-contributing-co-owner (who is subject to the tax) another Form 1099-INT with a copy to the IRS. In this example, Biff would get a Form 1099-INT. Biff is then supposed to give Anton a Form 1099-INT with a copy to the government.

**Double Taxation**

Double taxation can happen rather easily. The financial institution that redeems the bonds will issue a Form 1099-INT to the person redeeming the bond. The 1099-INT reflects the difference between the amount the holder receives and the purchase price. But as we have seen, several instances exist when a taxpayer is required to include as taxable income less than the amount shown on the 1099-INT. Examples are among the following:

- A taxpayer who reports the increase in the redemption value of the bond each year. The amount of interest shown on the 1099-INT will not be reduced by the amounts previously included in income.
- A taxpayer who receives a bond from a decedent. The 1099-INT will not be reduced by the interest reported by the decedent before death, on the decedent’s final return, or by the estate on the estate’s income tax return.
- A taxpayer (co-owner) acquires ownership of a bond through re-registration. The 1099-INT will not be reduced by the interest accrued prior to the re-registration of the bond, the tax on which may be due and owing by the principal co-owner.
- A taxpayer redeems a bond on which the taxpayer is the noncontributing co-owner. The principal co-owner previously reported accrued interest on the bond. The 1099-INT will not be reduced by the amounts the principal co-owner previously included as income.

Good records and communication on these matters is essential to avoid the double taxation trap.

**Taxable Events**

A taxable event is a transaction or occurrence that subjects an owner to the recognition of tax on the accumulated interest. An owner’s redemption of a bond ordinarily is a taxable event. A taxable event occurs when a bond reaches final maturity. Any accrued interest is taxable in the year that final maturity is reached. The re-registration of a bond may or may not be a taxable event.

Thus, principal (contributing) co-owner Anton who replaces co-owner Biff with co-owner Dick normally would not trigger a taxable event. A principal (contributing) co-owner Anton who takes his name off the bond altogether, however, likely would trigger a taxable event—and a tax to Anton.

**Tax Issues at Death**

Kleinrocket finally croaked. The executor or administrator of Kleinrocket’s estate had a few choices to make.

The executor may elect to report on Kleinrocket’s final income tax return the income earned up to the date of death. The rule applies if Kleinrocket was a grantor who transferred the bonds into an irre-
vocable trust.\textsuperscript{11} If bonds that were owned by a cash method owner who had chosen to report the interest each year are transferred because of death, the increase in value of the bonds (interest) in the year of death up to the date of death \textit{must} be reported on the decedent’s final return.\textsuperscript{12}

The election should save tax if the decedent is in a lower tax bracket than the co-owner (or the beneficiary). The transferee (estate, co-owner or beneficiary) then includes in its return only the interest earned after the date of death. Once made, the election by the estate cannot be revoked even if it is made under a mistake of fact as to who will inherit the bond.\textsuperscript{13}

A second choice for reporting the interest income exists. The executor is permitted to report the interest income on the \textit{estate} income tax return. This strategy should save tax if in our example Kleinrocket’s estate is in a lower bracket for income tax purposes. If this option is elected, the interest should not be included in Kleinrocket’s final return. Again, the transferee (estate, co-owner or beneficiary) reports on its return only the interest earned after the date of death.

If neither of these elections is made, the interest is classified as income in respect of the decedent (IRD).

\textit{Income in Respect of the Decedent (IRD)}

All income that the decedent would have received had death not occurred that was not includable on the final income tax return is income in respect of the decedent.\textsuperscript{14} Income in respect of a decedent must be included in the income of one of the following:

\begin{itemize}
  \item The decedent’s estate, if the estate receives it
  \item The co-owner or beneficiary, if the right to income is passed directly to the co-owner or beneficiary and the co-owner or beneficiary receives it
  \item Any person to whom the estate properly distributes the right to receive it
\end{itemize}

All of the interest earned before and after the decedent’s death is income to the transferee (estate, co-owner or beneficiary). A transferee who uses the cash method of accounting and who has not chosen to report the interest annually may defer reporting any of it until final maturity, redemption or disposition.\textsuperscript{15}

In the year the interest is reported, the transferee may claim a deduction for any federal estate tax paid that arose in respect to the subject interest (if any) included in the decedent’s estate.\textsuperscript{16}

Obviously, a careful analysis of the respective tax brackets of the decedent, the decedent’s estate and the beneficiary is necessary to figure out how best to minimize tax.

\section*{Education Planning}

Savings bonds also may be a tax-free way for parents to pay for a child’s education. The interest on EE or I bonds issued after December 31, 1989, may escape tax altogether if the parent pays for qualified higher education expenses in the year the bonds are redeemed.\textsuperscript{17}

Other restrictions exist. For instance, not only must a parent be at least 24 years of age when purchasing a bond, but the parents, if married, also must file a joint return in the year of redemption.

The exclusion is phased out as adjusted gross income (AGI) goes up. The phase-out is measured by the income of the parents in the year of redemption. Bonds bought in a child’s name are ineligible for the exclusion.

\section*{Retirement Planning}

Individuals who invest in savings bonds outside of a qualified retirement plan should consider liquidating other investments first and postpone redeeming their savings bonds until later in the retirement years. By the time such individuals redeem their bonds, not only would there be more tax-deferred growth, but the earlier liquidation of their other investments would reduce investment income, possibly putting them in a lower tax bracket than they would have been earlier in their retirement.\textsuperscript{18}

This is important because redeeming bonds usually results in many years of interest being reported in a lump sum in a single year. If there is not much other income reported in the redemption year, the individual could enjoy a diminished tax burden. On the other hand, redemption could push a taxpayer beyond the income ceiling, above which social security benefits would be subject to tax.

\section*{Gift Tax Consequences}

If Anton purchases bonds with Anton’s own funds and registers them in the name of Anton or Biff as co-owners, there is no gift at the time of purchase since Anton can redeem the bonds and regain the investment. A gift occurs only if Biff redeems the bonds for cash without obligation to Anton for any part of the proceeds\textsuperscript{19} or when Anton causes the bonds to be reissued in the sole name of Biff.

The value of the gift is the redemption value of the bonds at the time of the gift.\textsuperscript{20} If Biff redeemed the bonds and accounted to Anton
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for part of the proceeds, the gift is reduced by that amount. If Anton purchases savings bonds with his own funds and registers them in the name of Biff and Carl as co-owners, a gift to each occurs at the time of purchase in the amount of half of the purchase price of the bonds.21

For gift tax purposes, redemption value shown by IRS tables is the measure of the value of the gift. This is the case notwithstanding the fact that the contributing owner must include in his income appreciation up to the time of the redemption or reissue.22

Estate Tax Consequences

In the case of Anton who purchases savings bonds with his own funds and registers them in his name, or in his name and Biff’s as co-owners, the entire value of such bonds will, on Anton’s death, be includable in Anton’s gross estate under Code Sec. 2040(a).23

If Biff were Buffy, and if Anton and Buffy were husband and wife, then consistent with Code Sec. 2040(b), the estate of the first to die would include one-half of the value of the bonds for estate tax purposes. Even though now in certain states Anton and Biff might legally marry, federal law (including the tax code) would not recognize such marriage.24

If Anton and Biff were co-owners who both contributed to the purchase price and Anton died, the entire value of the jointly held property would be includable in Anton’s gross estate less such part as is proportionate to the amount of the purchase price furnished by Biff.25

If the bonds were purchased by Anton with his own funds and registered in the name of Biff and Carl as co-owners, on the death of Biff one-half of the value of the bonds at the time of death would be includable in Biff’s gross estate.26

If bonds are includable in a decedent’s gross estate, the amount includable is determined by the redemption value as shown by tables published monthly by the Treasury. Redemption value is the sole criterion for determining value for estate tax purposes. Again, this is the rule despite the fact that the appreciation component of the redemption value is taxable as income to the party chargeable with the liability.

The IRS has advised in Technical Advice Memorandum 20030301027 that the value of Series EE bonds cannot be discounted for lack of marketability to account for the income taxes due on the accrued interest because the only hypothetical willing buyer—the U.S. Government—would not take the income tax liability of the seller (the decedent’s estate) into account in its determination of the purchase (redemption) price of the bonds.

Tax-Free Conversion to Series HH bonds

Series EE bond owners may wish to continue to defer taxes on their interest income. Consistent with Code Sec. 1037(a), investors can exchange their Series EE savings bonds to the extent of their current value for Series HH bonds with no income being recognized at the time of conversion. The conversion must occur within one year of final maturity. The current value of Series EE savings bonds includes not only the original cost, but also the accrued interest at the time of the conversion. Thus, the accrued interest on the Series EE savings bonds can be used to purchase a greater amount of Series HH bonds and therefore generate additional interest income on the Series HH bonds. Interest income on the Series HH Savings Bonds is taxable when received for federal tax purposes; however, like Series EE or Series I Bonds the interest income would be excluded from an owner’s state, municipal or local income tax return.

The U.S. Treasury will cease issuing Series HH bonds after August 31, 2004.

Transfers, Dispositions and Trades of Savings Bonds

Generally, a transfer is accomplished by the execution of an owner’s request to reissue the bonds. Otherwise, the bonds are nontransferable—and may not be hypothecated, pledged or used as a security for the performance of an obligation.28

A transfer, including a gift or charitable contribution, is a disposition, and all interest accrued up until that time must be included in income in the year of transfer.29 This is true when a co-owner who bought the bonds transfers them (or has them re-issued) to the co-owner.30

For example, Anton bought a $1,000 Series EE savings bond with entirely his own funds and had it re-issued in his name and in his wife Buffy’s name as co-owner. Both spouses postponed reporting interest income on the bond. Anton later had the bond re-issued as two $500 bonds one in each spouse’s name. Anton must report one-half of the interest earned to the date of re-issue.

By contrast, a re-issuance in the sole name of the prior co-owner
who purchased it with his own funds is not an actual disposition or redemption and does not lead to taxation. When co-owners each contributed to the purchase of bonds, the tax treatment depends on the portion contributed as compared to the portion of ownership after the transfer. If bonds that co-owners bought jointly are reissued to each co-owner separately in the same proportion as the contribution to the purchase price, neither co-owner has to report at the time the interest earned before the bonds are re-issued.

For example, say Anton and Buffy spend an equal amount to buy a $1,000 Series EE Savings bond. The bond is issued to them as co-owners. Both postponed reporting interest on the bond. Anton and Buffy later have the bond reissued as two $500 bonds—one in each name. Neither spouse has to report the interest earned to the date of reissue.

If a co-owner owns a smaller portion after the transfer or re-issuance than the portion contributed, the co-owner must pay tax on the interest attributable to the difference.

A re-issuance immediately after a transfer to correct an error or owner registration is not treated as a taxable event. Thus, a purchaser (or recipient) should always check the names in which the bonds were issued and immediately request any changes necessary to avoid later taxation.

The deferred interest might be included in income even if the disposition itself is deemed a nontaxable transfer. For example, when savings bonds are transferred in a nontaxable transfer incident to a divorce, the accrued interest must be included in income by the transferor to the extent that it has not been already recognized by the transferor.

The transfer of a bond to a trust is a disposition and the unreported accrued interest should be included in income. The transfer of a bond with unreported accrued interest to a grantor trust is not considered a disposition and does not lead to taxation of the interest. Similarly, reissuing the bond in the name of the trustee of a grantor trust owned by the previous owner of the trust is not a disposition. In each case, there was no real change of ownership.

The exchange of Series EE bonds for Series HH bonds is not a taxable disposition—except to the extent that the taxpayer receives cash in the transaction.

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Special Situations

Foreign Transferees

Some countries do not have interest with respect to a decedent (IRD). Thus, depending on the subject tax treaty, a non-U.S. citizen co-owner or beneficiary may get a “step-up” in basis and avoid tax on the interest income. This can result in a significant tax savings.

Purchase, Holding and Redemption Timing

A bond purchased with good funds on the last day of the month is credited for a whole month’s worth of interest. A bond redeemed on the first day of the month is credited for a whole month’s worth of interest.

A Series EE or Series I bond redeemed within five years of purchase is subject to a forfeiture equal to the three most recent months’ interest.

Portability

For people on the run, savings bonds are useful investment vehicles. Creditors find bonds difficult to seize or to convert to cash. On the other hand, the owner, co-owner or beneficiary (with an acceptable copy of the owner’s death certificate) can redeem savings bonds at most commercial banks and at many savings and loans and credit unions—merely upon presentation of standard identification.

Lost or Stolen Bonds

Upon application and adequate showing, the Bureau of Public Debt will reissue to the owner lost, stolen or destroyed savings bonds. A savings bond is an unattractive object for a thief absent a fair likeness to and the picture ID of the owner.
Conclusion

After reading this article, hiring an accountant and clicking his heels, Strangelove was able to answer each issue that Kleinrocket’s savings bond portfolio presented.

Then, Strangelove read the article again as a soporific. It worked. Bonds away, dreamed Stangelove.

ENDNOTES


2 Reg. §1.454-1.

3 Reg. §1.454-1; Rev. Rul. 55-278, 1955-1 CB 399.


6 In re G. Hayes, CA-6, 407 F2d 1031 (1969);


7 Rev. Rul. 54-143, 1954-1 CB 12.


12 IRS Pub. 550, Investment Income and Expenses.

13 D.J. West, DC Ark., 89-2 USTC ¶9409, 701 FSupp 695.

14 Code Sec. 691(a).


16 Code Sec. 691(c).

17 Code Sec. 135.

18 68 PRAC. TAX STRATEGIES 89, 92 (West 2004).


23 See also Rev. Rul. 68-269, 1968-1 CB 399.

24 Defense of Marriage Act, 28 USC §1738C.


26 Id.

27 TAM 200303010 (Sept. 19, 2002).

28 See, e.g., M. Elliott Est., 57 TC 152 (1971); E.G. Chandler, 73-1 USTC ¶12,902, 410 US 257 (per curiam); 31 CFR §353.15-16; 31 CFR §360.15-16.

29 IRS Pub. 17, Your Federal Income Tax. See also LTR 8010082 (Dec. 13, 1979) (effort to make a lifetime charitable gift of a savings bond). It is possible, however, to transfer savings bonds to a charity upon the sole owner’s death without an income tax burden on the estate. LTR 9845026 (Aug. 11, 1998). If the recipient is a private foundation, the foundation will be liable for the two-percent excise tax on the interest income. Code Sec. 4940; Rev. Rul. 80-118, 1980-1 CB 254. I wish to thank Professor Christopher R. Hoyt for pointing out these charitable gift nuances.


34 Rev. Rul. 72-312, 1972-1 CB 22.


37 Code Sec. 1037.

38 Reg. §1.1037-1(a)(2).


40 Reg. §1.1037-1(a)(2).